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No. 08-___

IN THE

Supreme Court of the United States

STEPHEN S. ZIEGLER,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Whether the United States Court of Appeals for the Second Circuit erred in determining that the disallowance of Petitioner's taxable losses from an investment in a low income housing project predating a change in the relevant tax law disallowing such losses constituted a "taking" violating the due process clause of the Fifth Amendment to the Constitution of the United States.

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OPINIONS BELOW

The Opinion of the United States Tax Court, filed June 27, 2007, is reported at TC Memo 2007-166 (Appendix, *infra*, Exhibit B). The Opinion of the United States Court of Appeals for the Second Circuit, which took the form of a Summary Order filed June 26, 2008 (Appendix, *infra*, Exhibit A), is unreported. The Order of the United States Court of Appeals for the Second Circuit denying Petitioner's petition for a panel rehearing, filed October 7, 2008 (Appendix, *infra*, Exhibit C), is also unreported.

JURISDICTION

The Court of Appeals Summary Order was filed on June 26, 2008. The Court of Appeals Order denying a panel rehearing was filed on October 7, 2008. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Fifth Amendment to the Constitution of the United States ("Fifth Amendment") provides in relevant part:

> No person shall be . . . deprived of . . . property, without due process of law; nor shall private property be taken for public use, without just compensation.

Section 469 of the Internal Revenue Code, 26 U.S.C. §469, limiting passive activity losses and credits, is reproduced in the Appendix, *infra*, Exhibit E. Other relevant provisions of the tax law are discussed herein and, where deemed helpful to the Court, are reproduced in the Appendix with excerpts from pertinent legislative history.

STATEMENT

This case raises an important Constitutional issue involving Federal tax legislation enacted as part of the Tax Reform Act of 1986, Pub. Law No. 99-514 ("1986 Act"). This legislation in effect nullified with respect to investments predating its enactment decades of tax incentives designed to encourage investments in low and moderate income housing projects. The legislation had the effect of completely destroying the value of investments in such housing that significant numbers of taxpayers had made in

reliance upon the prior law. To Petitioner's knowledge the Court has not addressed this issue.

From 1968 through 1981, Congress and the Executive Branch explicitly recognized that government regulated low and moderate income housing projects provided no economic return and no possibility of economic recovery of investment. Hence, a series of laws were enacted to offer tax incentives to encourage investments in such projects. Later, in a truly unique ruling, the IRS stated that in view of said laws and their stated basis, a profit motive was not necessary in order for a taxpayer to deduct losses from such a project. However, Section 469 of the Internal Revenue Code ("Section 469" or the "passive loss limitation") eliminated all these tax incentives starting in 1987.

Petitioner asserts that the disallowance under the passive loss limitation of Petitioner's taxable losses from his investment in a housing project described below eliminated the only source of return from the investment and the only possibility of recovery of the investment. Accordingly, Section 469 effected a taking of Petitioner's investment in the project without compensation in violation of the Fifth Amendment.

I. PARTNERSHIP INTEREST AND LOSSES AT ISSUE

In Internal Revenue Service Forms 1040 for taxable years 1995-1999, Petitioner claimed taxable losses from a partnership, Aldus Green Company (the "Partnership"). The Partnership owned a government regulated and assisted low and moderate income housing project (a "GRLMH") named Aldus Green located in the Bronx, New York City, New

York (the "Project"). Petitioner held a 2% limited partner interest in the Partnership.

For the taxable years at issue (1995-1999), Petitioner deducted on Form 1040, U.S. Individual Income Tax Return, the losses the Partnership had reported to him. With each return, Petitioner filed a Form 8275 disclosing that in deducting the Aldus losses, he was taking positions contrary to the passive loss limitation. The IRS disallowed the claimed losses. After exhausting administrative remedies within the Internal Revenue Service, Petitioner sought relief from the United States Tax Court. The Tax Court, however, agreed with the IRS' disallowance of the losses. See Appendix, *infra*, Exhibit B.

II. ORIGIN OF PARTNERSHIP AND PROJECT

A. In General.

The Project consisted of 395 units spread across 11 buildings in a dire poverty area. In 1975-1977, the Project was developed as a substantial rehabilitation of existing structures by Aldus Green Associates ("Seller"). Seller's development of the Project was financed by equity contributions from its partners and a first mortgage. In 1984, the Seller sold the Project to the Partnership. See Appendix, *infra*, Exhibit G. The general partner of both the Partnership and the Seller was Herman I. Kraus. Kraus had been praised by government officials and the media as one of the most outstanding participants in the government housing programs.[1]

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[1] Petitioner became involved in the development of Kraus' GRLMHs as a result of Petitioner's pro bono work with Senator Robert Kennedy in drafting landmark 1967 legislation providing tax incentives for the development of GRLMH and undertaking

B. Government Assistance and Regulations.

The Project received governmental assistance as follows:

(1) The first mortgage was insured by the United States Department of Housing and Urban Development ("HUD") under Section 221(d)(4) of the National Housing Act. The mortgage bore a below market interest rate and a term longer than that of conventional financing.

(2) HUD paid a portion of the tenants' rentals under Section 8 of the United States Housing Act ("Section 8").

(3) The Project received an abatement of local real estate taxes under Article 4 of the NYS Private Housing Finance Law (the "PHFL") supervised by the New York State Division of Housing and Community Rental ("DHCR").

Rents and distributions of the Project were regulated by HUD and DHCR. Under the PHFL, Section 8 and regulations thereunder (the "Applicable Regulations"):

(1) The regulatory agencies were to set the rents at a level sufficient to pay: (a) operating expenses and real estate taxes, (b) debt service, (c) required reserves, and (d) a specified maximum return to the owner.

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successful efforts to have such tax incentives included in the Housing and Urban Development Act of 1968 and the Tax Reform Act of 1969.

(2) Distributions by the owner to its partners were limited to 6% of the owner's recognized equity in the project, as calculated under the Applicable Regulations. In reality, however, the actual return on equity was even more limited as explained immediately below.

C. Maximum Permitted Return Below Statutory Percentage and Actual Return of Zero.

Since the government agencies did not recognize all of the development costs of GRLMH, the maximum allowable return was less than 2% per annum of the actual equity. In fact, because of the manner in which the government programs operated, the owner of a project rarely received a significant part (or indeed in some cases any) of the maximum permissible cash flow. In other words, the governmental regulatory agencies arbitrarily set the initial rents at a level below that sufficient to pay any owner's return.

As the basis for any rent increase, the governmental agencies required a project income statement. The application would not be acted upon by the agencies until, e.g., two years after the submission by which time the costs would have further increased. In the case of housing projects regulated under Section 8, a major part of any increased rent was to be paid in large part by HUD assistance to the tenants. In certain periods, HUD lacked funds and/or authority to pay such assistance.

After 1986 and through the relevant taxable years, the Partnership did not realize positive cash flow. It distributed no cash to its partners. Generally receiving no part (or a nominal part) of the permissible

return and a great many mortgage defaults were typical under the housing programs.[2]

D. Sale of Project Not Reasonably Possible.

Under the Applicable Regulations, for 20 years after completion, the owner may sell a project only to a municipality or to another regulated company and for a price not exceeding of the cost of the project, less amounts paid in retirement of the mortgage. Any sale before or after said period is subject to the approval of DHCR and also requires prepayment of the mortgage.

There is a theoretical possibility that after the 20 years, the owner could prepay the mortgage, raise rents, and realize an economic return. However, in the case of the Project, this possibility did not accord with reality because the Project was located in a poverty area and, as required by Section 8, the tenants were low income persons. Any plan to evict low income minority group tenants from a poverty area project and replace them with tenants who could afford to pay substantially higher non-subsidized rentals was not a real possibility.

III. TAX INCENTIVES FOR GRLMH – THE LEGISLATIVE HISTORY.

From 1968 to 1981 the Executive Branch recommended and Congress approved as "national housing policy" a series of tax incentives for private investment in GRLMH (hereinafter the "Tax Incentives").[3]

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[2] See also, David Einhorn, Federal Tax Incentives and Federal Housing (1982).

[3] See Appendix, *infra*, Exhibit H.

The government formed the National Housing Partnership ("NHP"), a public-private organization to promote - and to participate in - the private development of GRLMH based on the Tax Incentives.

The legislative history of the Tax Incentives[4] specifically sets forth the collective understanding of Congress, the Executive Branch and the private sector as follows:

(a) The development and management of GRLMH involved major work and risks not involved in other real estate development.

(b) Apart from the Tax Incentives, there was no economic return from the investment and no prospect of recovery of the investment.

(c) The Tax Incentives were being offered as a means of involving private enterprise in the development of GRLMH.

(d) The methodology of the Tax Incentives.

(e) The great volume of GRLMH built based on the Tax Incentives.

IV. METHODOLOGY OF TAX INCENTIVES

The Tax Incentives operated as follows. In its early years a project would generate tax losses. Tax losses could result from expending cash (e.g., paying interest on a mortgage loan against the project) and also from making expenditures not involving an outlay of cash (e.g., tax depreciation on the project). A project typically would be owned by a partnership which would allocate the tax losses among its investors.

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[4] Salient provisions of this legislative history ("Legislative History") are reproduced in the Appendix, *infra*, Exhibit J.

Each investor could offset the investor's share of partnership tax losses against any income including wages, other compensation, dividends, and interest. Tax losses tended to be front-end loaded in that they were generated by (1) accelerated depreciation, (2) significant interest expense arising from the high ratio of mortgage debt to total project cost in GRLMH, and (3) the long amortization period of the mortgage which in the early years meant most of each payment on the mortgage represented deductible interest expense rather than nondeductible payments of principal.

In later years of the project's life (after the so called "turn around point"), the project would generate non-cash ("phantom") taxable income to the extent that the non-deductible mortgage amortization payments[5] exceeded the depreciation. In these years the investor would pay tax on the phantom income (which the investor would otherwise not incur) thereby "repaying" some of the prior tax savings.

Upon any sale, foreclosure or other transfer of a project, the investors would realize phantom (i.e., non-cash) gain representing relief from the balance of the mortgage exceeding any proceeds in cash and notes. Investors would be subject to tax on the gain. This tax would generally repay a major part of early years tax savings.[6]

The major tax benefit for an investment in GRLMH consisted of a deferral of tax - in effect, an interest free loan from the government (the "Deferral Bene-

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[5] In a level payment mortgage, as time passes, the interest component of the payments decreases and the principal amortization component increases.

[6] See Appendix, *infra*, Exhibit I.

fit"). The interest free loan represented the tax savings in the early years. These savings were repaid to some extent by additional tax on phantom income after the turn around point. Remaining benefits of the deferral were reversed once the project was sold or foreclosed.

The secondary tax benefit consisted of "conversion" or "rate arbitrage." Taxable gain on a sale or foreclosure would be taxed as capital gain, whereas in the early years tax losses had been deducted against ordinary income taxable at a higher rate (the "Savings Benefit").

The availability of these Tax Incentives was conditioned on the previously described requirements[7] that the housing program limit the income of the tenants, the rentals, and the cash flow distributable to the investors. The Project satisfied these requirements.

V. IRS' RECOGNITIONS OF TAX INCENTIVES AND LACK OF ECONOMIC RETURN FROM GRLMH

In Rev. Rul. 79-300, 1979-2 C.B. 112 (Appendix, *infra*, Exhibit N), the IRS recognized both the Tax Incentives for GRLMH and the need for such incentives in that the investments provided little if any economic return. In view of the explicit Congressional intention to provide Tax Incentives encouraging investments in GRLMH, the IRS ruled that GRLMH were excepted from the general rule requiring a profit motive for a real estate or other investment in order to deduct tax losses from the

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[7] See "B. Origin of the Partnership and Project – Government Assistance and Regulations" above.

investment. It is believed that no such ruling has been issued in regard to any other type of investment.

VI. THE PASSIVE LOSS LIMITATION

The 1986 Act added to the Internal Revenue Code the passive loss limitation under Section 469 to restrict deductions from tax shelter investments including those in rental real properties.

A. General Structure of Section 469.

Taxpayers subject to the passive loss limitation include individuals. For purposes of the passive loss calculations, an individual must take into account the individual's share of relevant items from passthrough entities including partnerships. Under Section 469, an individual (such as Petitioner) may deduct passive losses only against passive income and not against compensation income, business income or portfolio income.

Tax losses from investments in rental real property generally constitute passive losses.[8] Thus, tax losses from GRLMH generally must be characterized as passive losses that can offset only passive income.

B. Impact of Passive Loss Limitation on Investments in GRLMH.

By operation of Section 469, an investor (such as Petitioner) cannot offset tax losses from an invest-

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[8] The passive loss limitation was phased in over a five-year period from 1987 through 1991. This Petition concerns the Commissioner's disallowance of Ziegler's losses for taxable years 1995 through 1999. Thus, the case does not involve any interpretation of this general phase in rule. See, however, discussion below of a limited exemption.

ment in GRLMH against compensation income or interest and dividend income, which are excluded from passive income. However, many taxpayers such as Petitioner had invested in GRLMH, long before Section 469 existed, based solely on the expectation (valid under the law prior to Section 469) that they could offset deductions for project losses against compensation income.

The Deferral Benefit from investing in GRLMH as previously explained had consisted of realizing tax savings in the early years of the investment by offsetting the project losses in the early years against non-rental income, e.g., income from compensation or portfolio income, and repaying those savings by paying additional tax in later years. Section 469, however, permitted a taxpayer to offset passive (i.e., rental) losses from an investment only against passive income. Petitioner, like many other investors, had no source of significant passive income apart from his investment in the Project. As the Legislative History explicitly contemplated, Petitioner, like many other investors, had been induced by the Tax Incentives to invest in GRLMH expecting to offset tax losses in early years against compensation income thereby realizing early years tax savings. Under Section 469, Petitioner could no longer make that offset. Therefore, Petitioner could not realize the early year tax savings. The only times at which the Petitioner might have passive income from the Project were after the turnaround point, when a modest amount of phantom passive income would be realized, and when, if ever, the Project were sold or foreclosed at which time a phantom taxable gain would be realized. Section 469 thus eliminated the Deferral Benefit and any chance for Petitioner to recover his investment.

Section 469 also destroyed the Savings Benefit because previously disallowed passive losses generally can offset only gain on sale or foreclosure which gain would otherwise have been taxed as capital gains. Under the Tax Incentives, by contrast, the losses earlier would have offset income (e.g., compensation) which otherwise would have been taxed as ordinary income.

C. The Section 502 Exemption.

Pub. Law No. 99-514 § 502 provided an extremely limited partial exemption from Section 469 for certain GRLMH. The exemption was available only if: (a) the project was placed in service before August 16, 1986, (b) the investor made his initial investment after December 31, 1983, and (c) the investor's required payments after December 31, 1986 were at least 50% of the total original required investment. The exemption was available only for the shorter of (i) seven taxable years or (ii) one year after the pay-in period.

In this case, the Petitioner prior to 1986 had already paid in his entire investment and hence Petitioner was ineligible for this limited exemption. The unusual legislative history of Section 502 shows that Congress did not have an opportunity to consider a complete exemption for GRLMH (see Appendix, *infra*, Exhibit M).

VII. THE COURT OF APPEALS DECISION

The United States Tax Court upheld the IRS' disallowance of Petitioner's losses from the Partnership. See Appendix, *infra*, Exhibit B. The Court of Appeals affirmed the decision of the Tax Court. See Appendix, *infra*, Exhibits A and C. The Court of

Appeals agreed with the Tax Court that the application of Section 469 was not impermissibly retroactive. The Court also determined that the amendment of the Internal Revenue Code adding Section 469 had not violated the Due Process Clause of the Fifth Amendment. As support for this conclusion, the Court cited only *Story v. Green*, 978 F.2d 60 (2nd Cir. 1992).

REASONS FOR GRANTING THE PETITION

The Court of Appeals decision raises an important federal question in that the tax benefits it denied represent the sole source of return on and indeed recovery of an investment. By denying Tax Incentives from investments that predated the statute's enactment, the Second Circuit applied Section 469 retroactively.

The Court of Appeals erred in characterizing *Story v. Green* as a case involving a challenge to the "tax code." In any event, *Story v. Green* is distinguishable from this case.

The Court of Appeals decision conflicts with opinions of this Court. In numerous cases, this Court and other courts have held that retroactive changes in zoning and other laws in effect when claimant made an investment effected an unconstitutional taking of a protected interest in property. By reason of the Tax Incentives and the basis stated by the government for the incentives (i.e., there existed no other return from the investment or chance of recovering the investment other than the Tax Incentives), Petitioner's investment in the Project should be considered a constitutionally protected interest in property. Like the retroactive changes in zoning and other laws that this Court and other courts have

invalidated, Section 469 completely destroyed the economic value of Petitioner's investment in the Project.

I. THE COURT OF APPEALS DECISION ERRONEOUSLY RELIED ON *STORY v. GREEN*

In its Summary Order, the Second Circuit concluded that Section 469 did not violate the due process clause of the Fifth Amendment as an unconstitutional taking because Petitioner lacked "a property right to the tax benefits affected by the enactment of § 469." In support of this proposition, the Court solely cited *Story v. Green*, 978 F.2d 60 (2d Cir. 1992). In this regard, the Court of Appeals Summary Order stated:

> Nor does this change in the Internal Revenue Code violate the Due Process Clause of the 5th Amendment as an unconstitutional taking because Ziegler did not have a property right to the tax benefits affected by the enactment of § 469. See *Story v. Green*, 978 F.2d 60, 63 (2d Cir. 1992) (rejecting a Takings challenge to a change in the tax code).

For numerous reasons, the Second Circuit erred in relying on *Story v. Green*. First, *Story v. Green* did not involve a change in law on which anyone had relied in making an investment. Second, *Story v. Green* did not involve tax law. The decision invalidated a challenge to a state law repealing an exemption for disabled veterans from limitations on soliciting activity.

Moreover, *Story v. Green*, as applied by the Court of Appeals, is inconsistent with the cases (discussed below) in which this Court and other courts have held

that a change in zoning or other laws did amount to a taking without compensation when the affected person made an investment in reliance on the prior law. Changes in zoning/development laws cannot rationally be distinguished from changes in tax law because in both types of cases an injured person relied on the prior law in making an investment, and the change in law completely destroyed the person's investment.

In this case, no such distinction should be made especially because the Tax Incentives in reliance on which Petitioner invested in the Project were based on explicit recognition by all of Congress, the Executive Branch, and the IRS that the tax benefits were offered to induce the investment, and represented the only return from the investment and the only basis for recovery of the investment. Hence, under the rationale of the zoning and other decisions discussed below, a change in law (in this case, tax law) can and should be deemed a taking without compensation.

II. THE COURT HAS INVALIDATED LEGISLATIVE CHANGES AS TAKINGS WITHOUT COMPENSATION

In various cases, the Supreme Court has held that legislative changes in a prior zoning, development or other law effected a taking of an investment without compensation in violation of the Fifth Amendment when the prior law was relied on by plaintiff in making the investment, and the change completely destroyed the value of plaintiff's investment. These cases from the Supreme Court and other courts held that rights under zoning law in effect when the claimant purchased a property represented property interests protected under the Fifth Amendment.

In *Eastern Enterprises v. Appel*, 524 U.S. 498 (1998), the Supreme Court exhaustively set forth the criteria under which a change in law can constitute a "taking." The plaintiff was a successor owner of a coal mining enterprise. Plaintiff brought a declaratory judgment action to declare unconstitutional as a "taking without compensation" a provision of the United States Coal. . . Act of 1992. *Eastern* was a retroactivity case. Changing prior legislation, the Act imposed an obligation to pay benefits to a specified class of retired workers who had worked before 1966.

Highly relevant to the instant case is the Court's statement of the criteria to be applied in determining when changes in economic legislation effect a taking of property without compensation. The Court stated that these criteria apply even when (as in the instant case) the retroactive legislation was part of an overall program for the public good. The Court stated:

> Economic regulation such as the Coal Act may effect a taking. *United States v. Security Industrial Bank*, 459 U.S. 70, 78. The party challenging the government action bears a substantial burden, for not every destruction or injury to property by such action is a constitutional taking. A regulation's constitutionality is evaluated by examining the governmental actions 'justice and fairness.' See *Andrus v. Allard*, 444 U.S. 51, 65. Although that inquiry does not lend itself to any set formula, three factors traditionally have informed this Court's regulatory takings analysis: '[T]he economic impact of the regulation, its interference with reasonable investment backed expectations, and the character of the governmental action.' *Kaiser Aetna v. United States*, 444 U.S. 164, 175 ....

[T]he Coal Act substantially interferes with Eastern's reasonable investment-backed expectations. Retroactive legislation is generally disfavored. It presents problems of unfairness because it can deprive citizens of legitimate expectations and upset settled transactions. ...

...

The Takings Clause of the Fifth Amendment provides: '[N]or shall private property be taken for public use, without just compensation.' The aim of the Clause is to prevent the government 'from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.' *Armstrong v. United States*, 364 U.S. 40, 49 (1960) ... [E]conomic regulation such as the Coal Act may nonetheless effect a taking, see *Security Industrial Bank*, supra, at 78... By operation of the Act, Eastern is 'permanently deprived of those assets necessary to satisfy its statutory obligation, not to the Government, but to [the Combined Fund], ... and 'a strong public desire to improve the public condition is not enough to warrant achieving the desire by a shorter cut than the constitutional way of paying for the change,' *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 415 (1922) ... We have identified several factors, however, that have particular significance: '[T]he economic impact of the regulation, its interference with reasonable investment backed expectations, and the character of the governmental action.'...

Our Constitution expresses concern with retroactive laws through several of its provisions, including the Ex Post Facto and Takings

> Clauses. *Landgraf*, supra at 266 ... In *Security Industrial Bank*, we considered a Takings Clause challenge to a Bankruptcy Code provision permitting debtors to avoid certain liens, possibility including those predating the statute's enactment. We expressed 'substantial doubt whether the retroactive destruction of the appellees' liens ... comport[ed] with the Fifth Amendment,' and therefore construed the statute as applying only to lien interests vesting after the legislation took effect. 459 U.S., at 78-79. Similar concerns led this Court to strike down a bankruptcy provisions as an unconstitutional taking where it affected substantive rights acquired before the provision was adopted. *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 601-602 (1935) ... For similar reasons, the Coal Act substantially interferes with Eastern's reasonable investment-backed expectations ... Retroactivity is generally disfavored in the law, *Bowen v. Georgetown Univ. Hospital*, 488 U.S. 204, 208 (1988), in accordance with 'fundamental notions of justice' that have been recognized throughout history.

In other cases the Supreme Court and other Federal courts have held that changes in zoning, development and other laws resulted in a taking of property without compensation. See, for example:

ZONING AND DEVELOPMENT CASES:

> *Lucas v. South Carolina Coastal Company*, 505 US 1003 (1992) (state law changing prior law barred any development of plaintiff's beachfront land which "denies [plaintiff] all economically beneficial or productive use of [the] land");

- *Wheeler v. City of Pleasant Grove*, 664 F.2d 99 (4th Cir. 1981) (city zoning regulation barring any new apartment construction on previously held property as to which prior regulations permitted development; concurring Judge Kennedy distinguished *Carlton* based on the short duration of retroactivity in *Carlton*);

- *Urbanizadora Versailles, Inc.*, 701 F.2d (993) (1st Cir. 1983) (similar to *Wheeler* under Puerto Rico constitution – similar to US constitution – when freeze on land development was for 14 years);

- *Nollen v. California Coastal Commission*, 483 U.S. 825 (1987) (requirement of granting public easement as condition for grant of building permit);

- *Kaiser Aetna v. United States*, 444 U.S. 164 (1979) (taking found when Kaiser had dredged a pond and made other substantial expenditures in developing a marina subdivision, Army Corp. of Engineers advised Kaiser it was not required to obtain permit to dredge a pond and later, in a retroactive change, the government attempted to stop the dredging because the government wanted to make the pond a park).

OTHER CASES

- *Ruckelshaus v. Monsanto Co.*, 467 US 986 (1984) (change of prior law to authorize EPA to disclose trade secret health and environmental information submitted in support of an application to authorize sales of a pesticide product).

The Supreme Court's zoning and development law decisions are of particular relevance in this case and it is Petitioner's position that the Court of Appeals' decision is inconsistent with these Court decisions.

In one of these decisions, *Lucas v. South Carolina Coastal*, *supra*, the petitioner Lucas purchased two residential lots intending to build single-family homes on the lots. At that time of the purchase, the lots were not subject to the special building permit requirements of the state's applicable coastal zone legislation. In 1988, the State enacted legislation which changed the prior law by making the coastal zone regulations applicable to petitioner's lots. These regulations barred petitioner from developing any structures on his parcels.

The petitioner brought an action against the state claiming the change in law represented a taking without compensation. The Supreme Court held, although the change in law had a public purpose and was a valid exercise of the State's police power, the ban on construction deprived Lucas of all "economically viable use" of his property, and therefore represented a "taking" of his property without compensation under the Fourteenth Amendment.

The Court stated:

> Prior to Justice Holmes' exposition in *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393 (1922), it was generally thought that the Takings Clause reached only a 'direct appropriation' of property, Legal Tender Cases, 12 Wall. 457, 551 (1871), or the functional equivalent of a 'practical ouster of [the owner's] possession.' *Transportation Co. v. Chicago*, 99 U.S. 635, 642 (1879). See also *Gibson v. United States*, 166 U.S. 269, 275-276 (1897).

Justice Holmes recognized in Mahon, however, that, if the protection against physical appropriations of private property was to be meaningfully enforced, the government's power to redefine the range of interests included in the ownership of property was necessarily constrained by constitutional limits. 260 U.S., at 414-415. If, instead, the uses of private property were subject to unbridled, uncompensated qualification under the police power, the natural tendency of human nature [would be] to extend the qualification more and more until at last private property disappear[ed]. *Id.*, at 415. These considerations gave birth in that case to the oft-cited maxim that, "while property may be regulated to a certain extent, if regulation goes too far, it will be recognized as a taking." *Ibid.* [505 U.S. 1003, 1015]

Nevertheless, our decision in Mahon offered little insight into when, and under what circumstances, a given regulation would be seen as going 'too far' for purposes of the Fifth Amendment. In 70-odd years of succeeding 'regulatory takings' jurisprudence, we have generally eschewed any "set formula" for determining how far is too far, preferring to 'engag[e] in . . . essentially ad hoc, factual inquiries.' *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 124 (1978) (quoting *Goldblatt v. Hempstead*, 369 U.S. 590, 594 (1962)). See Epstein, Takings: Descent and Resurrection, 1987 S.Ct. Rev. 1, 4.

Regrettably, the rhetorical force of our 'deprivation of all economically feasible use' rule is greater than its precision, since the rule does not

> make clear the 'property interest' against which the loss of value is to be measured.
>
> The answer to this difficult question may lie in how the owner's reasonable expectations have been shaped by the State's law of property - i.e., whether and to what degree the State's law has accorded legal recognition and protection to the particular interest in land with respect to which the takings claimant alleges a diminution in (or elimination of) value.
>
> We think, in short, that there are good reasons for our frequently expressed belief that, when the owner of real property has been called upon to sacrifice all economically beneficial uses in the name of the common good, that is, to leave his property economically idle, he has suffered a taking.

Another relevant decision finding that a change in law resulted in a taking is *Ruckelshaus, Administrator, United States Environmental Protection Agency v. Monsanto Co., supra.* In *Ruckelshaus*, the Federal Insecticide, Fungicide, and Rodenticide Act ("FIFRA") required an applicant for registration of a pesticide to submit data to the Environmental Protection Agency ("EPA"). Under the initial legislation, the applicant could refer to certain of the information as "trade secrets" so it would not be publicly disclosed by EPA. A 1978 amendment to the Act for the first time authorized the EPA to disclose publicly the trade secret information.

The petitioner in Monsanto was a producer and seller of pesticides, and invested substantial sums in developing pesticides products. Monsanto claimed that the 1978 amendment authorized the disclosure

of Monsanto's trade secrets and was a taking of Monsanto property (the trade secrets) without compensation. The Court upheld Monsanto's legal position stating:

> The question of what constitutes a 'taking' is one with which this Court has wrestled on many occasions. It has never been the rule that only governmental acquisition or destruction of the property of an individual constitutes a taking, for 'courts have held that the deprivation of the former owner rather than the accretion of a right or interest to the sovereign constitutes the taking. Governmental action short of acquisition of title or occupancy has been held, if its effects are so complete as to deprive the owner of all or most of his interest in the subject matter, to amount to a taking.' *United States v. General Motors Corp.*, 323 U.S., at 378.
>
> See also *PruneYard Shopping Center v. Robins*, 447 U.S. 74 (1980); *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 415 (1922).
>
> As has been admitted on numerous occasions, 'this Court has generally 'been unable to develop any 'set formula' for determining when 'Justice and fairness' require that economic injuries caused by public action" must be deemed a compensable taking. *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979), quoting *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 124 (1978); accord, *Hodel v. Virginia Surface Mining & Reclamation Assn., Inc.*, 452 U.S. 264, 295 (1981).
>
> The Court, however, has identified several factors that should be taken into account when

> determining whether a governmental action has gone beyond 'regulation' and effects a 'taking.' Among those factors are: 'the character of the governmental action, its economic impact, and its interference with reasonable investment-backed expectations.' *PruneYard Shopping Center v. Robins*, 447 U.S., at 83; see *Kaiser Aetna*, 444 U.S., at 175; *Penn Central*, 438 U.S., at 124.

As set forth below, under the principles of these cases, the application of Section 469 to Petitioner's investment in the Project (with a resulting elimination of any possibility of return from the investment or a recovery of the investment) should be deemed a taking of Petitioner's investment without compensation.

III. FEDERAL COURTS HAVE ARTICULATED FACTORS INDICATING UNCONSTITUTIONAL TAKINGS

The cases indicate that in reviewing changes in legislation under the provision of the Fifth Amendment on takings, the courts have considered the following factors in determining whether the change represented as to the petitioner a "taking without compensation."

(1) Was there reliance by the petitioner on the prior law?

(2) Did the change in law merely correct an unintended error or omission in the prior law?

(3) What was the extent of the abrogation of rights? Was there merely a reduction of these rights (e.g., an increase in the tax rate), or a total destruction of the rights, in

which case the change would be deemed a taking without compensation?

(4) Did the legislation cut back on rights against the government itself as compared with rights against private parties?

(5) Did the change in law or regulation apply to a regulated industry, in which an affected person could not without consent take economic action to mitigate or offset the change?

IV. THE RELEVANT FACTORS AS APPLIED TO THE FACTS OF THIS CASE ESTABLISH THAT AN UNCONSTITUTIONAL TAKING OCCURRED

Under the above criteria, the application of Section 469 to Petitioner's investment in GRLMH predating the relevant change in the law (the enactment of Section 469 nullifying the Tax Incentives) should be deemed a violation of the Fifth Amendment as a taking of Petitioner's investment without compensation.

A. Reliance on Prior Law.

In order for a change in law to be an unconstitutional taking, the petitioner must show the petitioner made a substantial change of position in reliance upon the prior law. Clearly that criterion was satisfied in this case. Petitioner clearly would not have invested in the Project if Petitioner knew that the losses from the Project could not offset his compensation income. The fact that GRLMH had no economic return and no prospect of economic recovery of investment and that the tax incentives represented the only basis for making an investment in GRLMH

was specifically recognized in the Legislative History by Congress and the Executive Branch and later recognized by the IRS in Rev. Rul. 79-300. In the Legislative History, Congress and the Executive Branch specifically recognized that the Tax Incentives were being offered as the basis for encouraging investments in GRLMH.

This is not a case in which the government is taking away something which had been gratuitously conferred, e.g., a statute cutting back government grants. In this situation, Petitioner was induced to make an investment based solely upon a prior set of tax rules deliberately proposed by the Executive Branch and enacted by Congress to induce such investments.

B. The Application of Section 469 to Petitioner's Investment in Aldus Completely Destroyed the Investment.

As indicated in the cases cited above (e.g., *Lucas*), legislation which changes prior law relied upon in making an investment may be held unconstitutional as a taking without compensation only if the legislation completely destroyed the investment. In this case, the nullification of the Tax Incentives by Section 469 completed destroyed Petitioner's investment in the Project.

As previously explained, the Tax Incentives for investment in GRLMH consisted of (i) the ability to realize tax savings by offsetting project losses against all types of income, including in Petitioner's case compensation income, (ii) the Deferral Benefit, and (iii) the Savings Benefit.

As the IRS recognized in Rev. Rul. 79-300, an investment in GRLMH yields no significant economic

proceeds. Indeed, an economic loss is assured. By deferring the use of tax losses until a sale or foreclosure, Section 469 destroyed all the Tax Incentives and hence confiscated any return from the investment and any possibility of recovering the investment. Accordingly, the elimination of the Tax Incentives by the passive loss limitation constituted a total confiscation of the investment.

In general, the tax law (e.g., IRC § 183) requires that in order for losses from an activity or investment to be deductible, the investment must have a significant economic profit motive. Hence, if the investor in conventional housing or commercial buildings is deprived of tax benefits under Section 469, the investor cannot claim that his investment has been destroyed because, after all, the investor was required to have an economic profit motive apart from the tax consequences. By contrast, in a case involving GRLMH, since (as recognized by the IRS) there is no economic profit motive, the application of Section 469 assures a substantial loss from the investment. This is a key distinction as to why the application of Section 469 to investments in GRLMH effects a taking of property.

C. Section 469 Deferral of Deduction Does Not Mitigate the Taking.

In this case, the courts below tried to justify their decisions by pointing out that Section 469 does not completely disallow the loss deductions but only defers the deductions until the taxpayer realizes passive income. In the case of an investment in GRLMH an investor typically has passive income to a small extent after the turn around point and for the most part at the indefinite future time if ever when the project is sold or foreclosed. However, the fact

that Section 469 defers deductions from an investment in GRLMH rather than simply eliminating the deductions does not mitigate the taking. This is the case because as previously explained Section 469 eliminated both the Deferral Benefit and the Savings Benefit.

By eliminating the key Tax Incentives, Section 469 destroyed any chance of return on the investment or recovery of the investment.

D. The Section 502 Limited Exemption Did Not Mitigate but Only Accentuated the Taking.

The exemption from Section 469 of losses from GRLMH under Section 502 of the 1986 Act was limited to investors who had not paid in 50% of the amount of their investment and was limited to the remaining pay-in period, plus one year. An investor such as Petitioner who had paid in his entire investment was not eligible for the exemption.

In a direct parallel to the instant case, the Coal Act involved in *Eastern* limited the impact of the change to certain mine owners. The Court held that since this provision did not cover the liability imposed upon the Company, it did not ameliorate the taking of the Company's property. In this regard, the Court stated:

> We are also not persuaded by respondents' argument that the Coal Act 'moderate[s] and mitigate[s] the economic impact' upon Eastern. See *Connolly*, 475 U.S. at 225-226. Although Eastern is not assigned the premiums for former employees who later worked for companies that signed the 1978 NBCWA... The mere fact that Eastern is not forced to bear the burden of lifetime benefits respecting all of its former em-

> ployees does not mean that the company's liability for some of those employees is not a significant economic burden.

This is directly analogous to the impact of Section 502 in the instant case. Section 502 mitigated the effect of the retroactive change for certain project investors (those who had not paid in 50% of their investments), but not for Petitioner (who had paid in his entire investment). Hence, as to the Petitioner, the passive loss limitation amounted to a "taking."

The terms of this exemption constitute an egregious (indeed outrageous) breach of the government's clearly contemplated bargain with prior investors in GRLMH. Under the exemption, the government would pay the promised consideration for the investment (the tax benefits) only to the investors from whom the government had something further to gain (i.e., substantial further investments in the projects). As to the investors (such as the petitioner) who had already paid in their investment, the government had nothing further to gain. In applying Section 469 to these investors (who in reliance on the Tax Incentives had paid in their investments), the government was simply reneging on the consideration offered these investors.

E. Public Basis for Change in Law Does Not Bar a Finding that as to Certain Persons the Change Represented a Taking.

The above cases make it clear that a change in law can represent a taking as to certain affected persons, even though there is a valid and indeed important public purpose for the change in law.

In their rulings in the instant case, the Court of Appeals and the Tax Court relied on the public purpose for Section 469, that is, to curtail the revenue loss from tax shelters. However, as indicated by cases such as *Eastern* and *Lucas*, a public purpose for the taking should not bar a finding that there was a taking without compensation of the property of a person (like Petitioner) who relied on the prior law to make the investment, and as to whom the change totally eliminated any prospect of a return on the investment or recovery of the investment.

This is particularly the case in this matter, since Congress, the Executive Branch, and the IRS all recognized that there was no other return or prospect of recovery of the investment apart from the Tax Incentives under prior law.

F. Impact of Change in Law in Regulated Industry.

A change in law is more likely to result in a taking when the change affects a regulated industry and the persons affected by the change have had "no room" to take action to mitigate the impact of the change of law. For example, the owner of a GRLMH cannot raise rentals, because the increasing of rentals is under the direct control of the government lending or other regulatory authority, and indeed the tenants generally have no further rent paying capacity. In addition, the Applicable Regulations prohibit replacing low and moderate income tenants with more affluent tenants. See, e.g., *Phillips Petroleum Co. v. Dept of Energy*, 449 F. Supp 760 (D. Del. 1978), *aff'd sub nom Standard Oil Company v. Dept of Energy*, 596 F.2d 1029 (Em Ct. App.) (applying new standards retroactively to regulated prices in the petroleum industry), and *Essential Communications Systems v.*

AT&T, 466 F. Supp. 1090 (D.N.J. 1978) *rev'd on other grounds*, 610 F.2d 1114 (3rd Cir. 1979) (retroactive FCC regulatory change in certain custom-provided equipment traffic rates).

G. Rights Against Government

In several cases, the Court has invalidated as a violation of due process the application of a change in law to a transaction with the government previously held to be constitutional in regard to private transactions. See e.g.,:

1. *United States Trust Co. v. New Jersey*, 431 U.S. 1 (1979) *cert denied*, 431 U.S. 975 (law purporting to invalidate a covenant made by a state agency with bond holders);
2. *Lynch v. United States*, 292 U.S. 571 (1934) (act nullifying the rights of beneficiaries of war risk insurance policies issued by the government);
3. *Perry v. United States*, 294 U.S. 330 (1930) (joint resolution abrogating clauses in debt instruments requiring payment in gold as applied to a U.S. obligation).

The tax benefits in the instant case were enacted as part of a government social welfare program (that is, a program to provide GRLMH); they were not embodied in a contract between the government and the taxpayer-recipient.

CONCLUSION

Based on the previously discussed authorities, Petitioner respectfully asks that the Court grant this Petition in order to consider the merits of Petitioner's position that the application of Section 469 to Peti-

tioner's investment in GRLMH effected an unconstitutional taking of property without compensation.

Respectfully submitted,

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February 2009

APPENDIX

EXHIBIT A

SUMMARY ORDER OF UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT (JUNE 26, 2008)

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

[Filed JUN 26, 2008]

No. 07 4206–ag

STEPHEN S. ZIEGLER,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

SUMMARY ORDER

Rulings by summary order do not have precedential effect. Citation to summary orders filed after January 1, 2007, is permitted and is governed by this court's Local Rule 32.1 and Federal Rule of Appellate Procedure 32.1. In a brief or other paper in which a litigant cites a summary order, in each paragraph in which a citation appears, at least one citation must either be to the Federal Appendix or be accompanied by the notation: "(summary order)." A party citing a summary order must serve a copy of that summary order together with the paper in which the summary order is cited on any party not represented by counsel unless the summary order is available in an elec-

tronic database which is publicly accessible without payment of fee (such as the database available at http://www.ca2.uscourts.gov/). If no copy is served by reason of the availability of the order on such a database, the citation must include reference to that database and the docket number of the case in which the order was entered.

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 26th day of June, two thousand and eight.

PRESENT:

ROGER J. MINER,
JOSÉ A. CABRANES,
Circuit Judges.
RICHARD M. BERMAN,*
District Judge.

APPEARING FOR APPELLANT:

MICHAEL J. GRACE, Buchanan, Ingersoll & Rooney PC, Washington, DC.

APPEARING FOR APPELLEE:

TERESA T. MILTON, Attorney, (Nathan J. Hochman, Assistant Attorney General, Attorney, *on the brief*), Tax Division, United States Department of Justice, Washington, DC.

Appeal from a decision of the United States Tax Court (Carolyn P. Chiechi, *Judge*).

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* The Honorable Richard M Berman, Judge of the United States District Court for the Southern District of New York, sitting by designation.

UPON CONSIDERATION WHEREOF, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that the decision of the United States Tax Court is AFFIRMED.

Petitioner-appellant Stephen S. Ziegler appeals from a June 27, 2007 decision of the Tax Court concluding that the passive loss limitations rule, 26 U.S.C. § 469, can constitutionally be applied to losses attributable to an investment made by Ziegler before the enactment of the rule. *Ziegler v. Commissioner*, T.C.M. 23638-04, 2007 WL 1837131 (June 27, 2007). We assume the parties' familiarity with the facts and procedural history of the case. On appeal, Ziegler argues that (1) the retroactive application of § 469 to his investment violated his right to due process; (2) applying 469 to his investment resulted in an unconstitutional taking; and (3) the interim relief afforded by 26 U.S.C. § 502 violated his right to equal protection of the laws.[1]

We review the legal conclusions of the Tax Court *de novo. See, e.g., Reimels v. Commissioner,* 436 F.3d 344, 346 (2d Cir. 2006).

We find no constitutional violation here. We agree with the Tax Court that the application of § 469 was not impermissibly retroactive. By its express terms, § 469's limitations on passive loss deductions applies to losses incurred in the years following its enactment. *See* Pub. L. 104-188, § 704(d)(2). The fact that

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[1] At oral argument, Ziegler clarified that he raises an additional challenge, namely that the Tax Court and the Commissioner "coerced" him into abandoning an argument based on the Tax Court's alleged misinterpretation of the applicable regulations. Any such argument is entirely without merit. The record indicates that there was no improper coercion.

Ziegler made the investment associated with the passive activity losses prior to the enactment is of no consequence to the applicability of § 469 here. As we have previously noted, "[e]ach [passive activity loss] which takes place after the passage of the statute is subject to its terms. Therefore, after the effective date of the taxing statute, this [loss] was subject to taxation under its requirements. The taxing statute is not retroactive." *See Corliss v. Bowers,* 34 F.2d 656, 658 (2d Cir. 1929). Nor does this change in the Internal Revenue Code violate the Due Process Clause of the Fifth Amendment as an unconstitutional taking because Ziegler did not have a property right to the tax benefits affected by the enactment of § 469.[2] *See Story v. Green*, 978 F.2d 60, 63 (2d Cir. 1992) (rejecting a Takings challenge to a change in the tax code). We also conclude that the Tax Court properly rejected Ziegler's equal protection challenge because the interim relief granted by § 502 easily survives rational basis review. *See Madden v Kentucky*, 309 U.S. 83, 88 (1940). To maintain a successful equal protection challenge, Ziegler must "negative every conceivable basis which might support" the chal-

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[2] Ziegler contends that the Tax Court ignored his argument that the change in Internal Revenue Code "destroye[d] all of the Tax Incentives" associated with his investment, thereby eliminating any possibility of return Ziegler has not established before the Tax Court or our Court that his investment has been rendered valueless by § 469. For instance, the Commissioner suggests that Ziegler will realize some value upon the sale of his investment. It is irrelevant, for our purposes, whether the tax benefits Ziegler previously enjoyed were reduced or eliminated altogether; the result is the same *See, e.g., Story v. Green*, 978 F.2d 60, 63 (2d Cir. 1992) (concluding that legislation "altering or eliminating" a tax benefit does not violate the Due Process or Takings Clauses of the Constitution).

lenged distinction. *Id.* He has failed to raise a single argument in this respect.

For the reasons stated above, the decision of the Tax Court is AFFIRMED.

FOR THE COURT,

Catherine O'Hagan Wolfe,
Clerk of Court

By /s/ [Illegible]

EXHIBIT B

DECISION IN ZIEGLER v. COMMISSIONER, T.C. MEMO 2007-166

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

Docket No. 23638-04

STEPHEN S. ZIEGLER,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Memorandum Findings of Fact and Opinion of the Court filed on June 27, 2007, it is

ORDERED AND DECIDED that for the taxable years 1995, 1996, 1997, 1998, and 1999 there are due from petitioner the following deficiencies in, additions to, and accuracy-related penalties on petitioner's Federal income tax:

Year	Deficiency	Addition to Tax Under I.R.C. Sec. 6651(a)(1)	Accuracy-Related Penalty under I.R.C Sec. 6662(a)
1995	$12,112	$0.00	$2,308.60
1996	12,050	602.35	2,410.00
1997	28,819	2,881.40	5,763.80
1998	16,671	0.00	3,334.20
1999	19,665	0.00	3,933.00

T.C. MEMO. 2007-166

UNITED STATES TAX COURT

[Filed June 27, 2007]

Docket No. 23638-04

STEPHEN S. ZIEGLER,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

Michael J. Grace, for petitioner.

Roger W. Bracken, for respondent.

CHIECHI, *Judge*: Respondent determined the following deficiencies in, additions under section 6651(a)(1)[1] to, and accuracy-related penalties under section 6662(a) on petitioner's Federal income tax (tax)

Year	Deficiency	Addition to Tax	Accuracy-Related Penalty
1995	$12,112	$0.00	$2,308.60
1996	12,050	602.35	2,410.00
1997	28,819	2,881.40	5,763.80
1998	16,671	0.00	3,334.20
1999	19,665	0.00	3,933.00

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code (Code) in effect for the years at issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

The only issue remaining for decision is whether the application of section 469 to petitioner's claimed partnership losses for the respective years at issue violates the Due Process Clause of the Fifth Amendment to the Constitution of the United States.

FINDINGS OF FACT

All of the facts in this case, which the parties submitted under Rule 122, have been stipulated by the parties and are so found.[2]

Petitioner resided in Jericho, New York, at the time he filed the petition in this case.

Petitioner practiced law as a tax attorney for decades, specializing in providing legal services to developers of real property, including low-income apartment complexes similar to those purchased and operated by the partnership in which petitioner invested, as discussed below. During 1995 through 1999, the years at issue, petitioner practiced lam full time with the law firm of Ziegler, Sagal & Winters, PC, in New York, New York.

During the years at issue, petitioner was a limited partner of Aldus Green Company (Aldus Green), a limited partnership formed under the laws of the State of New York. As a limited partner of Aldus Green, petitioner owned two percent of Aldus Green's capital, profits, and losses.

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[2] In violation of Rule 143(b), petitioner alleges on brief various facts (petitioner's alleged facts) not stipulated by the parties and not otherwise supported by the record in this case. In further violation of that Rule, petitioner attached to his opening brief various documents (petitioner's documents) that are not part of the record and that the Court had returned to petitioner. We shall not rely on petitioner's alleged facts or petitioner's documents.

In 1984, Aldus Green purchased and operated certain low-income rental apartment buildings located in Bronx, New York. Aldus Green rented apartments in those buildings to low-income individuals, who received rent subsidies under section 8 of the United States Housing Act, as amended.

Petitioner filed Form 1040, U.S. Individual Income Tax Return, for each of his taxable years 1995 through 1999 (petitioner's returns). In each such return, petitioner claimed in Schedule E, Supplemental Income and Loss (Schedule E), a loss attributable to his investment in. Aldus Green (petitioner's claimed Aldus Green loss) in arriving at "Total partnership and S corporation income or (loss)" in each such schedule. As a result, in Schedule E for each of the years at issue, petitioner claimed a. total partnership and S corporation loss. In each of petitioner's returns for the years at issue, petitioner offset the total partnership and S corporation loss claimed in Schedule E against income from other sources in arriving at total income for each such year.

Respondent issued to petitioner a notice of deficiency (notice) with respect to his taxable years 1995 through 1999. In that notice, respondent determined petitioner's claimed Aldus Green loss for each of those years to be a passive activity loss under section 469, allowed each such loss to the extent of income from passive activities for each such year, and disallowed the following amount of petitioner's claimed Aldus Green loss for each such year:

Year	Amount
1995	$44,108
1996	52,415
1997	44,495
1998	41,317
1999	48,773

OPINION

Petitioner concedes that petitioner's claimed. Aldus Green loss for each of the years at issue is a passive activity loss as defined in section 469(d)(1) and that section 469(a) disallows each such loss.[3] It is petitioner's position, however, that the application of section 469 to petitioner's claimed Aldus Green loss for each of the years at issue violates the Due Process Clause of the Fifth Amendment (Due Process Clause) to the United States Constitution (Constitution) and that therefore he should be allowed to offset each such loss against his income from sources other than passive activities for each such year. (We shall refer to income from sources other than passive activities as other income.)

In support of his position under the Due Process Clause, petitioner argues that section 469 is retroactive and that the retroactive application of section 469 to petitioner's claimed Aldus Green loss for each of the years at issue is unconstitutional. In further support of his position, petitioner argues that the transitional rule that Congress provided in enacting section 469 into the Code (transitional rule) violates his equal protection rights under the Due Process Clause because it treats him differently than certain other taxpayers.

The Due Process Clause provides that "No person shall be * * * deprived of life, liberty, or property, without due process of law". The Due Process Clause provides protection against Federal discriminatory

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[3] Petitioner also concedes that he is liable for additions to tax under sec. 6651(a)(1) for the taxable years 1996 and 1997 and for accuracy-related penalties under sec. 6662(a) for all the taxable years at issue.

action "so unjustifiable as to be violative of due process". *Shapiro v. Thompson*, 394 U.S. 618, 642 (1969); *see Nicholas v. Tucker*, 114 F.3d 17, 19 (2d Cir. 1997). The Due Process Clause also has been held to incorporate the Equal Protection Clause of the Fourteenth Amendment to the Constitution. *Johnson v. Robison*, 415 U.S. 361, 364-365 n.4 (1974); *Hammond v. Lenfest*, 398 F.2d 705, 709 n.6 (2d Cir. 1968).

Before considering petitioner's constitutional arguments, we shall summarize in pertinent part the legislative history and provisions of section 469. On October 22, 1986, Congress enacted section 469 into the Code in the Tax Reform Act of 1986, Pub. L. 99-514 (1986 Act or TRA 1986), sec. 501(a), 100 Stat. 2233. In the report of the Senate Committee on Finance (Senate Finance Committee Report) with respect to the 1986 Act, that committee set forth the following reasons for enacting section 469:

> In recent years, it has become increasingly clear that taxpayers are losing faith in the Federal income tax system. This loss of confidence has resulted in large part from the interaction of two of the system's principal features: its high marginal rates * * *, and the opportunities it provides for taxpayers to offset income from one source with tax shelter deductions and credits from another.
>
> The prevalence of tax shelters in recent years * * * has been well documented. * * *
>
> Such patterns give rise to a number of undesirable consequences, even aside from their effect in reducing Federal tax revenues. Extensive shelter activity contributes to public concerns that the tax system is unfair, and to the belief

that tax is paid only by the naive and the unsophisticated. This, in turn, not only undermines compliance, but encourages further expansion of the tax shelter market, in many cases diverting investment capital from productive activities to those principally or exclusively serving tax avoidance goals.

The committee believes that the most important sources of support for the Federal income tax system are the average citizens who simply report their income (typically consisting predominantly of items such as salaries, wages, pensions, interest, and dividends) and pay tax under the general rules. To the extent that these citizens feel that they are bearing a disproportionate burden with regard to the costs of government because of their unwillingness or inability to engage in tax-oriented investment activity, the tax system itself is threatened.

Under these circumstances, the committee believes that decisive action is needed to curb the expansion of tax sheltering and to restore to the tax system the degree of equity that is a necessary precondition to a beneficial and widely desired reduction in rates. So long as tax shelters are permitted to erode the Federal tax base, a low-rate system can provide neither sufficient revenues, nor sufficient progressivity, to satisfy the general public that tax liability bears a fair relationship to the ability to pay. In particular, a provision significantly limiting the use of tax shelter losses is unavoidable if substantial rate reductions are to be provided to high-income taxpayers without disproportionately reducing the share of total liability under the individual

> income tax that is borne by high-income taxpayers as a group.

S. Rept. 99-313, at 713-714 (1986), 1986-3 C.B. (Vol. 3) 713-714.

In the Senate Finance Committee Report, the Senate Committee on Finance focused specifically on the use of rental activities for tax shelter purposes, such as the use by Aldus Green of rental activities for such purposes. That report stated in pertinent part:

> The extensive use of rental activities for tax shelter purposes under present law, combined with the reduced level of personal involvement necessary to conduct such activities, make clear that the effectiveness of the basic passive loss provision could be seriously compromised if material participation were sufficient to avoid the limitations in the case of rental activities.

Id. at 718.

Having summarized the concerns of Congress in enacting section 469 into the Code, we shall now summarize certain provisions of that section that are pertinent here. Pursuant to section 469(a), a taxpayer is not allowed to offset a passive activity loss for the taxable year against other income for such year. For purposes of section 469, a passive activity loss for the taxable year is the amount, if any, by which the aggregate losses from all passive activities for the taxable year exceed the aggregate income from all passive activities for such year. Sec. 469(d)(1); sec. 1.469-2T(b)(1), Temporary Income Tax Regs., 53 Fed. Reg. 5711 (Feb. 25, 1988). The term "passive activity" is defined in pertinent part as any activity in which the taxpayer does not materially participate. Sec. 469(c)(1). Any rental activity is a passive activity,

regardless whether the taxpayer materially participates in the activity. *See* sec. 469(c)(2).

Under section 469(b), a passive activity loss is treated as a deduction allocable to the passive activity giving rise to such loss for the succeeding taxable year. Under that section, a passive activity loss may be carried forward indefinitely. In addition, section 469(g)(1) provides in pertinent part:

> SEC. 469. PASSIVE ACTIVITY LOSSES AND CREDITS LIMITED.
>
> * * *
>
> (g) Dispositions of Entire Interest in Passive Activity—If during the taxable year a taxpayer disposes of his entire interest in any passive activity (or former passive activity), the following rules shall apply:
>
> (1) Fully taxable transaction.—
>
> (A) In general—If all gain or loss realized on such disposition is recognized, the excess of
>
> (i) any loss from such activity for such taxable year (determined after the application of subsection (b)), over
>
> (ii) any net income or gain for such taxable year from all other passive activities (determined after the application of subsection (b)),
>
> shall be treated as a loss which is not from a passive activity.

We now turn to petitioner's arguments. We first address his argument that section 469 is retroactive. Petitioner maintains that section 469 is retroactive because:

> The effect of the 1986 Act passive loss provisions is to deny a current deduction for depreciation (*i.e.*, a segment of the expenditure) for a property already purchased, and for interest on a mortgage loan already committed, to the extent that said deductions exceed the net operating income from the property. In this case, the expenditures were made by the Partnership [Aldus Green]—and the taxpayer made his investment in the Partnership—before the law was enacted or proposed and the passive loss rule is disallowing the deduction for the expenditure.

In support of his argument that section 469 is retroactive, petitioner contends that he decided to invest in Aldus Green in 1984.[4] According to petitioner, "Based on the tax incentives in place at that time, Petitioner reasonably expected that he would be allowed to deduct tax losses from the Partnership" and "would not have made the investment if he knew that the losses from the project could not be offset against his compensation and portfolio income, since in that case, there would be no economic return from the investment." Petitioner maintains that he was "induced to make an investment based upon the prior set of tax rules deliberately enacted by Congress to induce such investment." From those premises, petitioner argues that section 469 is retroactive and that such retroactivity is unconstitutional because it violates the Due Process Clause.

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[4] With respect to petitioner's contention that he made his investment in Aldus Green in 1984, respondent states on brief: "We note that petitioner offered no evidence that his investment in AGC [Aldus Green] actually was made two years before the enactment of sec. 469, nor was the date of his investment in AGC contained in the Stipulation of Facts filed in this case."

Before considering petitioner's argument that section 469 is unconstitutionally retroactive, we note that the grounds on which petitioner relies to support that argument are similar to the grounds on which the taxpayer relied in *United States v. Carlton*, 512 U.S. 26 (1994), to support his argument that the tax statute involved there was unconstitutionally retroactive. In *Carlton*, the taxpayer, the executor of an estate, maintained that the retroactive amendment of a Federal estate tax provision (section 2057) violated the Due Process Clause because he "specifically and detrimentally relied on the pre amendment version", *id.*, at 33, of that provision when he engaged in a transaction prior to its amendment by Congress. *Id.* In rejecting the taxpayer's position, the Supreme Court of the United States observed that the taxpayer's

> reliance alone is insufficient to establish a constitutional violation. Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code. Justice Stone explained in *Welch v. Henry*, 305 U.S., at 146-147:
>
> > "Taxation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe due process . . . ."
>
> Moreover, the detrimental reliance principle is not limited to retroactive legislation. An entirely prospective change in the law may disturb the relied-upon expectations of individuals, but such

> a change would not be deemed therefore to be violative of due process.

Id. at 33-34.

We consider now whether, as petitioner argues, section 469 is retroactive. As pertinent here, section 469(a) applies only to a passive activity loss as defined in section 469(d)(1) for a taxable year that began after December 31, 1986. *See* TRA 1986 sec. 501(c), 100 Stat. 2241. Section 469(a) does not apply to any loss for any taxable year that began prior to January 1, 1987. *See id.* We hold that section 469 is not retroactive.[5]

We next address petitioner's argument that the transitional rule that Congress provided in enacting section 469 into the Code violates his equal protection rights under the Due Process Clause. We first describe the transitional rule that Congress provided, TRA 1986 sec. 502, 100 Stat. 2241, when it enacted section 469 into the Code. That transitional rule provides that any loss sustained by certain investors[6]

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[5] *See Polone v. Commissioner*, T.C. Memo. 2003-339, *affd.* 479 F.3d 1019 (9th Cir. 2007); *cf. United States v. Carlton*, 512 U.S. 26, 33-34 (1994).

[6] The investors qualifying under the transitional rule are so-called qualified investors. The term "qualified investor" is defined to mean, in general:

> any natural person who holds (directly or through 1 or more entities) an interest in a qualified low-income housing project—
>
> (A) if—
>
> (i) in the case of a project placed in service before August 16, 1986, such person held an interest in such project on August 16, 1986, and the taxpayer made his initial investment after December 31, 1983, or

with respect to interests in certain low-income housing projects[7] for any taxable year in a prescribed period[8] is not to be treated as a loss from a passive

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(ii) in the case of a project not described in subparagraph (A), such investor held an interest in such project on December 31, 1986, and

(B) if such investor is required to make payments after December 31, 1986, of 50 percent or more of the total original obligated investment for such interest.

TRA 1986 sec. 502(d), 100 Stat. 2242.

[7] The low-income housing projects qualifying under the transitional rule are so-called qualified low-income housing projects. The term "qualified low-income housing project" is defined to mean:

any project if—

(1) such project meets the requirements of clause (i), (ii), (iii) , or (iv) of section 1250 (a) (1) (B) as of the date placed in service and for each taxable year thereafter which begins after 1986 and for which a passive loss may be allowable with respect to such project,

(2) the operator certifies to the Secretary of the Treasury or his delegate that such project met the requirements of paragraph (1) on the date of the enactment of this Act [October 22, 1986] (or, if later, when placed in service) and annually thereafter,

(3) such project is constructed or acquired pursuant to a binding written contract entered into on or before August 16, 1986, and

(4) such project is placed in service before January 1, 1989.

TRA 1986 sec. 502(c), 100 Stat. 2242.

[8] The period prescribed under the transitional rule is a so-called relief period. The term "relief period" is defined to mean:

the period beginning with the taxable year in which the investor made his initial investment in the qualified low-income housing project and ending with whichever of the following is the earliest—

activity for purposes of section 469. TRA 1986 sec. 502(a), 100 Stat. 2241.

In support of his argument that the transitional rule violates his equal protection rights under the Due Process Clause, petitioner contends that, because he is not entitled to the relief provided by the transitional rule, Congress treated him differently than certain other taxpayers entitled to such relief. According to petitioner, the provisions of the transitional rule are "arbitrary, capricious and unreasonable". In support of that claim, petitioner asserts:

> In this case, the conditions for the 1986 Act exemptions for low and moderate income housing are worse than unreasonable, that is, worse than conditions without any reasonable basis. The conditions evidence, and indeed were meant to evidence, an intention by the opponents of any exemption to take private property without compensation.
>
> The exemption is conditional upon the taxpayer not having yet paid in over 50%- of the taxpayer's investment commitment. It is obvious and beyond dispute—that the purpose of this condition was to encourage the taxpayer to pay in the balance of his investment—and this was the very purpose of the tax incentives for sub-

---

(1) the 6th taxable year after the taxable year in which the investor made his initial investment,

(2) the 1st taxable year after the taxable year in which the investor is obligated to make his last investment, or

(3) the taxable year preceding the 1st taxable year for which such project ceased to be a qualified low-income housing project.

TRA 1986 sec. 502(b), 100 Stat. 2241.

> sidized housing in the first place. However, there is no exemption for the investor who has already paid in his investment, even if he is an investor in the same project as a taxpayer who has not yet paid in his investment.
>
> Hence, limiting the exemption to investors who have not yet paid in over 50% of their investments reflects a purpose antithetical to our system of jurisprudence, that is, perpetuating a fraud by having the government pay a further portion of the consideration it promised to persons who had not yet completed their performance in reliance on the government's promised consideration to the persons who had already fully performed in reliance upon the government promise. [Reproduced literally.]

In order to prevail on his equal protection argument, petitioner must show that the transitional rule was not premised upon a rational basis, *see Regan v. Taxation With Representation*, 461 U.S. 540, 547-548 (1983), and instead was premised upon an impermissible basis such as race, religion, or the desire to prevent the exercise of petitioner's constitutional rights, *see United States v. Berrios*, 501 F.2d 1207, 1211 (2d Cir. 1974).

We reject petitioner's argument that the transitional rule violates his equal protection rights under the Due Process Clause. In enacting section 469, Congress considered whether any relief from the application of section 469(a) was appropriate. After giving consideration to that question, Congress decided to provide in the transitional rule certain relief,

but only for certain taxable years, to certain taxpayers in certain circumstances.[9]

On the instant record, we find that petitioner has failed to carry his burden of establishing that the transitional rule was not premised upon a rational

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[9] Congress also decided to provide in sec. 469(m) certain other relief, but only for certain taxable years, to taxpayers who were not entitled to the relief provided by the transitional rule and who therefore were subject to sec. 469. Sec. 469(m) provides in pertinent part:

> SEC. 469. PASSIVE ACTIVITY LOSSES AND CREDITS LIMITED.
>
> * * *
>
> (m) Phase-in of Disallowance of Losses and Credits for Interest Held Before Date of Enactment.—
>
> (1) In general—In the case of any passive activity loss or passive activity credit for any taxable year beginning in calendar years 1987 through 1990, subsection (a) shall not apply to the applicable percentage of that portion of such loss (or such credit) which is attributable to preenactment interests.
>
> (2) Applicable percentage—For purposes of this subsection, the applicable percentage shall be determined in accordance with the following table:

In the case of taxable Years beginning in:	The applicable percentage is:
1987	65
1988	40
1989	20
1990	10

Sec. 469(m)(3)(B)(i) defines the term "pre-enactment interest" to mean, in general, "any interest in a passive activity held by a taxpayer on the date of the enactment of the Tax Reform Act of 1986, and at all times thereafter." Petitioner appears to have qualified for the relief from the application of sec. 469(a) that Congress provided in sec. 469(m).

basis and instead was based upon a constitutionally impermissible standard. We hold that the transitional rule does not violate petitioner's equal protection rights under the Due Process Clause.

We have considered all of the parties' contentions and arguments that are not discussed herein, and we find them to be without merit, irrelevant, and/or moot.

To reflect the foregoing and the concessions of petitioner,

Decision will be entered for respondent.

EXHIBIT C

ORDER OF UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DENYING PANEL REHEARING (OCTOBER 7, 2008)

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
THURGOOD MARSHALL U.S. COURT HOUSE
40 FOLEY SQUARE, NEW YORK, N.Y. 10007

No. 07-4206-ag

STEPHEN S. ZIEGLER,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 7th day of October two thousand eight.

Catherine O'Hagan Wolfe
CLERK OF COURT

Before: Hon. Roger J. Miner,
Hon. Jose A. Cabranes,
Circuit Judges,
Hon. Richard M. Berman,*
District Judge.

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* The Honorable Richard M. Berman, Judge of the United States District Court for the Southern District of New York, sitting by designation.

ORDER

Stephen S. Ziegler having filed a petition for panel rehearing and the panel that determined the appeal having considered the request,

IT IS HEREBY ORDERED that the petition is denied.

FOR THE COURT:

Catherine O'Hagan Wolfe, Clerk

BY: /s/ Richard Alcantara
Richard Alcantara, Deputy Clerk

EXHIBIT D

NOTICE OF DEFICIENCY
DATED SEPTEMBER 20, 2004

Department of Treasury
Internal Revenue Service
Appeals Office
195 Commerce Way
Suite B
Portsmouth, NH 03801

Date: Sep 20, 2004

Letter Number: 894(cg)-c

Person to Contact:
Thomas D Leary

Employee ID Number:
02-00344

Tel: (603) 433-0547

Fax: (603) 433-0780

Refer Reply to:
AP:TS:PSM:TDL

In Re:
STEPHEN & HARRIET
ZIEGLER

Form Number:
1040

SSN/EIN Number:
062-28-0530

Last Day to File a Petition
with the United States
Tax Court: Dec 12, 2004

STEPHEN & HARRIET ZIEGLER
6 CLUB DRIVE NORTH
JERICO NY 11753-1128

Certified Mail

Notice of Deficiency

Tax Year(s) Ended	Tax	Penalties or Additions to Tax	
		6662(a)	6651(a)(1)
December 31, 1995	$12,112.00	$2,308.60	$0.00
December 31, 1996	$12,050 00	$2.410.00	$602.35
December 31. 1997	$28.819.00	$5,763.80	$2,881.40
December 31. 1998	$16,671.00	$3,334.20	$0.00
December 31, 1999	$19,665.00	$3,933.00	$0.00

Dear Mr. Grace:

We have determined that you owe additional tax or other amounts, or both, for the tax year(s) identified above. This letter is your NOTICE OF DEFICIENCY as required by law. The enclosed statement shows how we figured the deficiency.

If you want to contest this determination in court before making any payment, you have 90 days from the date of this letter (150 days if this letter is addressed to you outside of the United States) to file a petition with the United States (U.S.) Tax Court for a redetermination of the deficiency. You can get a copy of the rules for filing a petition and a petition form you can use by writing to the address below:

United States Tax Court
400 Second Street, NW
Washington DC 20217

The Tax Court has a simplified procedure for small tax cases when the amount in dispute for each tax year is $50,000 or less. If you intend to file a petition

for multiple tax years and the amount in dispute for any one or more of the tax years exceeds $50,000, this simplified procedure is not available to you. If you use this simplified procedure, you cannot appeal the Tax Court's decision. You can get information pertaining to the simplified procedure for small cases from the Tax Court by writing to the court at the above address or from the court's internet site at www.ustaxcourt.gov.

Send the completed petition form, a copy of this letter, and copies of all statements and/or schedules you received with this letter to the Tax Court at the above address. The court cannot consider your case if you file the petition late. The petition is considered timely filed if the postmark date falls within the prescribed 90 or 150 day period and the envelope containing the petition is properly addressed with the correct postage.

The time you have to file a petition with the court is set by law and cannot be extended or suspended. Thus, contacting the Internal Revenue Service (IRS) for more information, or receiving other correspondence from the IRS won't change the allowable period for filing a petition with the Tax Court.

As required by law, separate notices are sent to husbands and wives. If this letter is addressed to both husband and wife, and both want to petition the Tax Court, both must sign and file the petition or each must file a separate, signed petition. If only one spouse petitions the Tax Court, the full amount of the deficiency will be assessed against the non-petitioning spouse. If more than one tax year is shown above, you may file one petition form showing all of the years you are contesting.

If you decide not to file a petition with the Tax Court, please sign the enclosed waiver form and return it to us at the IRS address on the top of the first page of this letter. This will permit us to assess the deficiency quickly and can help limit the accumulation of interest. The enclosed envelope is for your convenience.

If you decide not to sign and return the waiver, and you don't file a petition with the Tax Court within the time limit, the law requires us to assess and bill you for the deficiency after 90 days from the date of this letter (150 days if this letter is addressed to you outside the United States).

If you are a C corporation, under Internal Revenue Code Section 6621(c), large corporate underpayments may be subject to a higher rate of interest than the normal rate of interest for underpayments.

If you have questions about this letter, you may write to or call the contact person whose name, telephone number, and IRS address are shown on the first page of this letter. If you write, please include your telephone number, the best time for us to call you if we need more information, and a copy of this letter to help us identify your account. Keep the original letter for your records. If you prefer to call and the telephone number is outside your local calling area, there will be a long distance charge to you.

The contact person identified on the front of this letter can access your tax information and help you get answers. You also have the right to contact the office of the Taxpayer Advocate. You can call 1-877-777-4778 and ask for Taxpayer Advocate assistance. Or you can contact the Taxpayer Advocate for the IRS office that issued this notice of deficiency by

calling (603) 433- 0571 or writing to 80 Daniel Street, Portsmouth, NH 03801. Taxpayer Advocate assistance is not a substitute for established IRS procedures such as the formal appeals process. The Taxpayer Advocate is not able to reverse legally correct tax determinations, nor extend the time fixed by law that you have to file a petition in the U.S. Tax Court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling.

Thank you for your cooperation.

Sincerely,

Mark W. Everson
Commissioner
By

/s/ Robin B. Lawhorn
Robin B. Lawhorn
Team Manager

Enclosures:
Envelope
Audit Statement
Copy of this Letter
Form 4089
Form 4089A
Explanation of Tax Changes

cc: Stephen & Harriet Ziegler

Form 4089 (Rev January 1983)	Department of the Treasury - Internal Revenue Service **Notice of Deficiency - Waiver**	Symbols: AP:TS:PSM:TDL

Name(s), SSN or EIN, and address of taxpayer(s)

STEPHEN & HARRIET ZIEGLER
6 CLUB DRIVE NORTH
JERICHO NY 11753

062-28-0530

Kind of Tax	X Copy to Authorized Representative
Income	MICHAEL J. GRACE, ESQ. BUCHANAN INGERSOLL P.C. 1776 K STREET, N.W. SUITE 800 WASHINGTON DC 20006-2365

Tax Year Ended	Deficiency		
	Increase in Tax	Penalties or Additions to Tax	
		6662(a)	6651(a)(1)
12/1995	$12,112.00	$2,308.60	$0.00
12/1996	$12,050.00	$2,410.00	$602.35
12/1997	$28,819.00	$5,763.80	$2,881.40
12/1998	$16,671.00	$3,334.20	$0.00
12/1999	$19,665.00	$3,933.00	$0.00

Interest, as provided by law, will be charged on the unpaid liability until it is paid in full.
See the attached explanation for the above deficiencies

I consent to the immediate assessment and collection of the deficiencies (increase in tax and penalties) shown above, plus any interest provided by law.

Your Signature _____ *(Date signed)*

Spouse's Signature, If A Joint Return Was Filed _____ *(Date signed)*

Taxpayer's Representative Sign Here _____ *(Date signed)*

Corporate Name: _____

Corporate Officers Sign Here _____ *(Signature)* *(Title)* *(Date signed)*

_____ *(Signature)* *(Title)* *(Date signed)*

Note:

If you consent to the assessment of the amounts shown in this waiver, please sign and return it in order to limit the accumulation of interest and expedite our bill to you. Your consent will not prevent you from filing a claim for refund (after you have paid the tax) if you later believe you are entitled to a refund. It will not prevent us from later determining, if necessary, that you owe additional tax, nor will it extend the time provided by law for either action.

If you later file a claim and the Internal Revenue Service disallows it, you may file suit for refund in a district court or in the United States Claims Court, but you may not file a petition with the United States Tax Court.

Who Must Sign

If this waiver is for any year(s) for which you filed a joint return, both you and your spouse must sign the original and duplicate of this form. Sign your name exactly as it appears on the return. If you are acting under power of attorney for your spouse, you may sign as agent for him or her.

For an agent or attorney acting under a power of attorney, a power of attorney must be sent with this form if not previously filed.

For a person acting in a fiduciary capacity (executor, administrator, trustee), file Form 56, Notice Concerning Fiduciary Relationship, with this form if not previously filed.

For a corporation, enter the name of the corporation followed by the signature and title of the officer(s) authorized to sign.

If you agree, please sign one copy and return it; keep the other copy for your records.

Form 4089-A (Rev 04/1982)	artment of the Treasury - Internal Revenue Service **Notice of Deficiency - Statement**	Symbols: AP:TS:PSM:TDL

STEPHEN & HARRIET ZIEGLER
6 CLUB DRIVE NORTH
JERICHO NY 11753

SSN\EIN: 062-28-0530

Interest, as provided by law, will be charged on the unpaid liability until it is paid in full.

Kind of Tax:
Income

Tax Year(s) Ended	Deficiency (Increase in Tax and Penalties)		
	Deficiency	6662(a)	6651(a)(1)
12/1995	$12,112.00	$2,308.60	$0.00
12/1996	$12,050.00	$2,410.00	$602.35
12/1997	$28,819.00	$5,763.80	$2,881.40
12/1998	$16,671.00	$3,334.20	$0.00
12/1999	$19,665.00	$3,933.00	$0.00

_x_ Copy to Authorized Representative:

ACCURACY-RELATED PENALTY:

Since all or part of the understatements of tax for the taxable years ended December 31, 1995, December 31, 1996, December 31, 1997, December 31, 1998 and December 31, 1999 are attributable to one or more of the following: (1) negligence of disregard of rules or regulations, (2) any substantial understatement of income tax, or (3) any substantial valuation overstatement, a 20% addition to the tax is charged as provided by Section 6662(a) of the Internal Revenue Code.

Delinquency . Addition to the Tax, Section 6651(a)(1)

Since you did not file your return for the tax years 1996 and 1997 within the time prescribed by law, and you did not show the such failure was due to reasonable cause and not due to willful neglect, a section 6651 (a)(1) failure to file penalty of 5 percent of the net amount due is added to the tax for each month for which your return was late. This penalty cannot exceed 25 percent. In addition, since you did not show that such failure was due to reasonable cause and not willful neglect, a 6651(a)(2) failure to pay of 0.5 percent of the net amount due will be added to the tax for each month, or part of a month, for which such failure continues. This penalty cannot exceed 25 percent.

The amount of the penalty imposed under section 6651(a)(1) will be reduced by the amount of

the penalty imposed under section 6651(a)(2) for any month or part of a month during which both penalties apply

Form 5278 (Rev. July 2002)	Department of the Treasury - Internal Revenue Se **Statement - Income Tax Changes**	Schedule I

1. Name(s) of Taxpayer(s)	2. ☑ Notice of Deficiency ☐ Other (specify) ☐ Settlement Computation
Stephen & Harriet Ziegler	

3. Taxpayer Identification Number	4. Form Number	5. Docket Number	6. Office Symbols
062-28-0530	1040		AP:TS:PSM:TDL:JC

7. Adjustments to Income	Tax Years Ended 12/31/1995	12/31/1996	12/31/1997
a. Itemized Deductions	(12,536)	(13,103.00)	34,326.00
b. Schedule E - Passive Loss, Aldus Green Assoc.	44,108.00	52,415.00	44,495.00
c. Constructive Dividends	2,320.00		
d. Exemptions			742.00
e.			
f.			
g.			
h.			
8. Total Adjustments	33,892.00	39,312.00	79,563.00
9. Taxable Income as shown in: ☐ Preliminary letter dated ☐ Notice of Deficiency dated ☑ Return as filed	280,473.00	135,403.00	139,562.00
10. Taxable Income as revised	314,365.00	174,715.00	219,125.00
Filing Status / Method	Joint Tax Table	Schedule D	Schedule D
11. Tax	100,177.00	44,857.00	61,930.00
12. Alternative Tax, if applicable			
13. Alternative Minimum Tax *(Starting tax year 2000)*			
14. Corrected Tax Liability - *(lesser of line 11 or 12 plus line 13)*	100,177.00	44,857.00	61,930.00
15. Less Credits: a. Prior Year Minimum Tax Credit	4,883.00		
b.			
c.			
16. Balance - *(line 14 less total of lines 15a - 15c)*	95,294.00	44,857.00	61,930.00
17. Plus Other Taxes: a		0.00	0.00
b			
c			
18. Total Corrected Tax Liability - *(line 16 plus lines 17a - 17c)*	95,294.00	44,857.00	61,930.00
19. Total Tax Shown on Return or as Previously Adjusted	83,182.00	32,807.00	33,111.00
20. Increase (Decrease) in Tax	12,112.00	12,050.00	28,819.00
Adjustments Increase (decrease) to: 20a. Earned Income Credit			
20b. Additional Child Tax Credit			
20c. Fuels Credit / Other			
21. Deficiency - Increase in Tax or (Overassessment - Decrease in Tax) - *(line 20 adjusted by lines 20a - 20c)*	12,112.00	12,050.00	28,819.00
22. Adjustments to Prepayment Credits - Increase (decrease)	0.00	0.00	0.00
23. Balance Due or (Overpayment) Excluding Interest and penalties - *(line 21 adjusted by line 22)*	12,112.00	12,050.00	28,819.00
24. Penalties and/or Additions To Tax *(listed below)*			
Accuracy §6662(a)	2,308.60	2,410.00	5,763.80
Delinquency §6651(a)(1)	0.00	502.35	2,881.40

Form 5278 (Rev. July 2002)	Department of the Treasury - Internal Revenue Ser **Statement - Income Tax Changes**	Schedule II

1. Name(s) of Taxpayer(s)	2. ☑ Notice of Deficiency ☐ Other (specify) ☐ Settlement Computation
Stephen & Harriet Ziegler	

3. Taxpayer Identification Number	4. Form Number	5. Docket Number	6. Office Symbols
062-28-0530	1040		AP:TS:PSM TDL:JC

	Tax Years Ended		
7. Adjustments to Income	12/31/1998	12/31/1999	
a. Itemized Deductions	2,066.00	2,438.00	
b. Schedule E - Passive Loss, Aldus Green Assoc	41,317.00	48,773.00	
c. Constructive Dividends			
d. Exemptions			
e.			
f.			
g			
h			
8. Total Adjustments	43,383.00	51,211.00	
9. Taxable Income as shown in ☐ Preliminary letter dated ☐ Notice of Deficiency dated ☑ Return as filed	260,481.00	266,090.00	
10. Taxable Income as revised	303,864.00	317,301.00	
Filing Status	Joint		
Method	Schedule D	Schedule D	
11. Tax	93,123.00	98,812.00	
12. Alternative Tax, if applicable			
13. Alternative Minimum Tax *(Starting tax year 2000)*			
14. Corrected Tax Liability - *(lesser of line 11 or 12 plus line 13)*	93,123.00	98,812.00	
15. Less Credits a.			
b.			
c.			
16. Balance - *(line 14 less total of lines 15a - 15c)*	93,123.00	98,812.00	
17. Plus Other Taxes a.			
b.			
c.			
18. Total Corrected Tax Liability - *(line 16 plus lines 17a - 17c)*	93,123.00	98,812.00	
19. Total Tax Shown on Return or as Previously Adjusted	76,452.00	79,147.00	
20. Increase (Decrease) in Tax	16,671.00	19,665.00	
Adjustments Increase (decrease) to 20a. Earned Income Credit			
20b. Additional Child Tax Credit			
20c. Fuels Credit / Other			
21. Deficiency - Increase in Tax or (Overassessment - Decrease in Tax) - *(line 20 adjusted by lines 20a - 20c)*	16,671.00	19,665.00	
22. Adjustments to Prepayment Credits - Increase (decrease)			
23. Balance Due or (Overpayment) Excluding interest and penalties - *(line 21 adjusted by line 22)*	16,671.00	19,665.00	
24. Penalties and/or Additions To Tax *(listed below)*			
Accuracy §6662(a)	3,334.20	3,933.00	
Delinquency §6651(a)(1)	0.00	0.00	

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Stephen & Harriet Ziegler		Year/Period Ended December 31, 1995, 1996, 1997, 1998 & 1999

a. Itemized Deductions

It is determined your itemized deductions are $238,220.00, $188,832.00, $112,339.00, $76,193.00 and $77,100.00 instead of $225,684.00, $175,729.00 $146,665.00, $78,259.00 and $79,538.00, as reported on your tax returns for the tax years 1995, 1996, 1997, 1998, and 1999 respectively. You are allowed charitable deductions of $168,542.00, $112,109.00, and $36,291.00 instead of $154,613.00, $96,385.00 and $68,392.00 as reported on the tax returns for 1995, 1996, and 1997 respectively. Also, due to audit adjustments, your Adjusted Gross Income is changed and the amount of itemized deduction allowable is changed. Accordingly, taxable income is decreased $12,536.00 and $13,103.00, for tax years 1995, and 1996 respectively and increased $34,326.00, $2,066.00 and $2,438.00 for tax years 1997, 1998, and 1999 respectively. See Schedules 1, 2, 3, 4, and 5 for a detail of the changes.

b. Schedule E -Passive Loss, Aldus Green Associates

It is determined that the losses you claimed on your Schedule E from Aldus Green Associates as non-passive in tax years 1995, 1996, 1997, 1998 and 1999 are passive activity losses.. A passive activity is one involving the conduct of a trade or business in which you do not materially participate, or any rental activity unless the requirements of Section 469 (c)(7) of the Internal Revenue Code are met in tax years beginning after December 31,1993. Passive losses can only be offset against passive income. Rather, these losses must be carried forward in accordance with IRC Section 469(b) Your passive activity losses have been allowed to the extent of passive income as shown in the table below, and are not deductible against ordinary income for the tax years 1995, 1996, 1997, 1998, and 1999, respectively. Accordingly, taxable income is increased $ 44,108.00, $52,415.00, 44,495.00, $41,317.00 and $48,773.00 for the tax years 1995, 1996, 1997, 1998, and 1999 respectively.

Year	Per Return	Per Audit	Adjustment
1995	44,108.00	0.00	44,108.00
1996	60,578.00	8,163.00	52,415.00
1997	47,414.00	2,919.00	44,495.00
1998	48,252.00	6,935.00	41,317.00
1999	54,348.00	5,575.00	48,773.00

c. Constructive Dividends

It is determined that you received constructive dividends of $2,320 from Ziegler, Sagal and Winters, PC in the tax year 1995. Accordingly, taxable income is increased $2,320 for the tax year 1995.

d. Exemptions

It is determined that the amount you can claim for your exemptions is reduced if your income is more than the dollar limit for your filing status. Your income is more than that limit, so we reduced the amounts you can claim. For tax year 1997 you are allowed $ 0.00 in itemized deductions instead of $742.00 as claimed on your tax return. Accordingly, taxable income is increased in the amounts of $742.00 for the tax year 1997.

PENALTIES AND/OR ADDITIONS TO TAX

Accuracy-Related Penalty §6662(a)

It is determined that you are liable for the accuracy-related penalty imposed under Section 6662(a) of the Internal Revenue Code for the tax years 1995, 1996, 1997, 1998, and 1999 because there was (1) a substantial understatement of income tax, (2) valuation misstatement(s), or (3) you were negligent or disregarded rules or regulations. You have not shown you had reasonable cause for the underpayment of tax or that any exceptions to the penalty apply. The penalty is 20 percent of the portion of the underpayment of tax attributable to each component of this penalty.

Delinquency Penalty §6651(a)(1)

Since you did not file your return for the tax years 1996 and 1997 within the time prescribed by law, and you did not show the such failure was due to reasonable cause and not due to willful neglect, a section 6651 (a)(1) failure to file penalty of 5 percent of the net amount due is added to the tax for each month for which your return was late. This penalty cannot exceed 25 percent. In addition, since you did not show that such

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Stephen & Harriet Ziegler		Year/Period Ended December 31, 1995, 1996, 1997, 1998 & 1999

failure was due to reasonable cause and not willful neglect, a 6651(a)(2) failure to pay of 0.5 percent of the net amount due will be added to the tax for each month, or part of a month, for which such failure continues. This penalty cannot exceed 25 percent.

The amount of the penalty imposed under section 6651(a)(1) will be reduced by the amount of the penalty imposed under section 6651(a)(2) for any month or part of a month during which both penalties apply. See computations at Schedules 14 and 15.

Schedule 1

Name Of Taxpayer: Stephen & Harriet Ziegler
Identification Number: 062-28-0530

07/01/2004
Total 4.00.00

1995 - SCHEDULE A - ITEMIZED DEDUCTIONS

	PER RETURN	PER EXAM	ADJUSTMENT
1. Medical, dental and insurance premiums	0.00	0.00	0.00
2. 7.50% of Adjusted Gross Income	37,962.00	41,444.00	
3. Net Medical and Dental Expense	0.00	0.00	0.00
4. Taxes	44,574.00	44,574.00	0.00
5. Home Interest Expense	33,545.00	33,545.00	0.00
6. Investment Interest	4,696.00	4,696.00	0.00
7. Other Interest Expense	0.00	0.00	0.00
8. Total Interest Expense	38,241.00	38,241.00	0.00
9. Contributions	154,613.00	168,542.00	(13,929.00)
10. Casualty and theft Losses	0.00	0.00	0.00
11. Moving Expenses	0.00	0.00	0.00
12. Miscellaneous deductions subject to AGI limit	0.00	0.00	0.00
13. 2.00% of Adjusted Gross Income	10,123.00	11,052.00	
14. Excess Miscellaneous deductions	0.00	0.00	0.00
15. Other Miscellaneous deductions	0.00	0.00	0.00
16. Total itemized deductions (Sum of Lines 3,4,8, 9,10,11,14, and 15 less any applicable limitation)	225,684.00	238,220.00	(12,536.00)

ITEMIZED DEDUCTIONS WORKSHEET - PER EXAM

A. Total of lines 3, 4, 8, 9, 10, 11, 14, and 15	251,357.00
B. Total of lines 3, 6, 10, (plus any gambling losses included on line 15)	4,696.00
C. Line A less Line B	246,661.00
D. Multiply the amount on line C by 80%	197,329.00
E. Adjusted Gross Income from Form 1040	552,585.00
F. Itemized Deduction Limitation	114,700.00
G. Line E less Line F	437,885.00
H. Multiply the amount on Line G by 3%	13,137.00
I. Enter the smaller of Line D or Line H	13,137.00
J. Total Itemized Deductions (entered on line 16 above)	238,220.00

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Schedule 2

Name Of Taxpayer: Stephen & Harriet Ziegler
Identification Number: 062-28-0530

07/01/2004
Total 4.00.00

1996 - SCHEDULE A - ITEMIZED DEDUCTIONS

	PER RETURN	PER EXAM	ADJUSTMENT
1. Medical, dental and insurance premiums	0.00	0.00	0.00
2. 7.50% of Adjusted Gross Income	23,335.00	27,266.00	
3. Net Medical and Dental Expense	0.00	0.00	0.00
4. Taxes	29,666.00	29,666.00	0.00
5. Home Interest Expense	45,460.00	45,460.00	0.00
6. Investment Interest	6,962.00	6,962.00	0.00
7. Other Interest Expense	0.00	0.00	0.00
8. Total Interest Expense	52,422.00	52,422.00	0.00
9. Contributions	96,385.00	112,109.00	(15,724.00)
10. Casualty and theft Losses	0.00	0.00	0.00
11. Moving Expenses	0.00	0.00	0.00
12. Miscellaneous deductions subject to AGI limit	9,274.00	9,274.00	0.00
13. 2.00% of Adjusted Gross Income	6,223.00	7,271.00	
14. Excess Miscellaneous deductions	3,051.00	2,003.00	1,048.00
15. Other Miscellaneous deductions	0.00	0.00	0.00
16. Total itemized deductions (Sum of Lines 3,4,8, 9,10,11,14, and 15 less any applicable limitation)	175,729.00	188,832.00	(13,103.00)

ITEMIZED DEDUCTIONS WORKSHEET - PER EXAM

A. Total of lines 3, 4, 8, 9, 10, 11, 14, and 15	196,200.00
B. Total of lines 3, 6, 10, (plus any gambling losses included on line 15)	6,962.00
C. Line A less Line B	189,238.00
D. Multiply the amount on line C by 80%	151,390.00
E. Adjusted Gross Income from Form 1040	363,547.00
F. Itemized Deduction Limitation	117,950.00
G. Line E less Line F	245,597.00
H. Multiply the amount on Line G by 3%	7,368.00
I. Enter the smaller of Line D or Line H	7,368.00
J. Total Itemized Deductions (entered on line 16 above)	188,832.00

Page 2 of 2

Schedule 3

Name Of Taxpayer: Stephen & Harriet Ziegler
Identification Number: 062-28-0530

07/01/2004
Total 4.00.00

1997 - SCHEDULE A - ITEMIZED DEDUCTIONS

	PER RETURN	PER EXAM	ADJUSTMENT
1. Medical, dental and insurance premiums	0.00	0.00	0.00
2. 7.50% of Adjusted Gross Income	21,523.00	24,860.00	
3. Net Medical and Dental Expense	0.00	0.00	0.00
4. Taxes	28,649.00	28,649.00	0.00
5. Home Interest Expense	41,490.00	41,490.00	0.00
6. Investment Interest	9,414.00	9,414.00	0.00
7. Other Interest Expense	0.00	0.00	0.00
8. Total Interest Expense	50,904.00	50,904.00	0.00
9. Contributions	68,392.00	36,291.00	32,101.00
10. Casualty and theft Losses	0.00	0.00	0.00
11. Moving Expenses	0.00	0.00	0.00
12. Miscellaneous deductions subject to AGI limit	9,432.00	9,432.00	0.00
13. 2.00% of Adjusted Gross Income	5,739.00	6,629.00	
14. Excess Miscellaneous deductions	3,693.00	2,803.00	890.00
15. Other Miscellaneous deductions	0.00	0.00	0.00
16. Total itemized deductions (Sum of Lines 3,4,8, 9,10,11,14, and 15 less any applicable limitation)	146,665.00	112,339.00	34,326.00

ITEMIZED DEDUCTIONS WORKSHEET - PER EXAM

A. Total of lines 3, 4, 8, 9, 10, 11, 14, and 15	118,647.00
B. Total of lines 3, 8, 10, (plus any gambling losses included on line 15)	9,414.00
C. Line A less Line B	109,233.00
D. Multiply the amount on line C by 80%	87,386.00
E. Adjusted Gross Income from Form 1040	331,464.00
F. Itemized Deduction Limitation	121,200.00
G. Line E less Line F	210,264.00
H. Multiply the amount on Line G by 3%	6,308.00
I. Enter the smaller of Line D or Line H	6,308.00
J. Total Itemized Deductions (entered on line 16 above)	112,339.00

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Schedule 4

Name Of Taxpayer: Stephen & Harriet Ziegler 07/01/2004
Identification Number: 062-28-0530 Total 4.00.00

1998 - SCHEDULE A - ITEMIZED DEDUCTIONS

	PER RETURN	PER EXAM	ADJUSTMENT
1. Medical, dental and insurance premiums	0.00	0.00	0.00
2. 7.50% of Adjusted Gross Income	25,406.00	28,504.00	
3. Net Medical and Dental Expense	0.00	0.00	0.00
4. Taxes	26,149.00	26,149.00	0.00
5. Home Interest Expense	45,703.00	45,703.00	0.00
6. Investment Interest	8,674.00	8,674.00	0.00
7. Other Interest Expense	0.00	0.00	0.00
8. Total Interest Expense	54,377.00	54,377.00	0.00
9. Contributions	2,600.00	2,600.00	0.00
10. Casualty and theft Losses	0.00	0.00	0.00
11. Moving Expenses	0.00	0.00	0.00
12. Miscellaneous deductions subject to AGI limit	8,335.00	8,335.00	0.00
13. 2.00% of Adjusted Gross Income	6,775.00	7,601.00	
14. Excess Miscellaneous deductions	1,560.00	734.00	826.00
15. Other Miscellaneous deductions	0.00	0.00	0.00
16. Total itemized deductions (Sum of Lines 3,4,8, 9,10,11,14, and 15 less any applicable limitation)	78,259.00	76,193.00	2,066.00

ITEMIZED DEDUCTIONS WORKSHEET - PER EXAM

A. Total of lines 3, 4, 8, 9, 10, 11, 14, and 15	83,860.00
B. Total of lines 3, 8, 10, (plus any gambling losses included on line 15)	8,674.00
C. Line A less Line B	75,186.00
D. Multiply the amount on line C by 80%	60,149.00
E. Adjusted Gross Income from Form 1040	380,057.00
F. Itemized Deduction Limitation	124,500.00
G. Line E less Line F	255,557.00
H. Multiply the amount on Line G by 3%	7,667.00
I. Enter the smaller of Line D or Line H	7,667.00
J. Total Itemized Deductions (entered on line 16 above)	76,193.00

Schedule 5

ame Of Taxpayer: Stephen & Harriet Ziegler 07/01/2004
entification Number: 062-28-0530 Total 4.00.00

1999 - SCHEDULE A - ITEMIZED DEDUCTIONS

	PER RETURN	PER EXAM	ADJUSTMENT
1. Medical, dental and insurance premiums	0.00	0.00	0.00
2. 7.50% of Adjusted Gross Income	25,922.00	29,580.00	
3. Net Medical and Dental Expense	0.00	0.00	0.00
4. Taxes	29,148.00	29,148.00	0.00
5. Home Interest Expense	39,848.00	39,848.00	0.00
6. Investment Interest	7,670.00	7,670.00	0.00
7. Other Interest Expense	0.00	0.00	0.00
8. Total Interest Expense	47,518.00	47,518.00	0.00
9. Contributions	4,618.00	4,618.00	0.00
10. Casualty and theft Losses	0.00	0.00	0.00
11. Moving Expenses	0.00	0.00	0.00
12. Miscellaneous deductions subject to AGI limit	11,738.00	11,738.00	0.00
13. 2.00% of Adjusted Gross Income	6,913.00	7,888.00	
14. Excess Miscellaneous deductions	4,825.00	3,850.00	975.00
15. Other Miscellaneous deductions	0.00	0.00	0.00
16. Total itemized deductions (Sum of Lines 3,4,8, 9,10,11,14, and 15 less any applicable limitation)	79,538.00	77,100.00	2,438.00

ITEMIZED DEDUCTIONS WORKSHEET - PER EXAM

Total of lines 3, 4, 8, 9, 10, 11, 14, and 15	85,134.00
Total of lines 3, 6, 10, (plus any gambling losses included on line 15)	7,670.00
Line A less Line B	77,464.00
Multiply the amount on line C by 80%	61,971.00
Adjusted Gross Income from Form 1040	394,401.00
Itemized Deduction Limitation	126,600.00
Line E less Line F	267,801.00
Multiply the amount on Line G by 3%	8,034.00
Enter the smaller of Line D or Line H	8,034.00
Total Itemized Deductions (entered on line 16 above)	77,100.00

BEST AVAILABLE COPY

Schedule 6

Name of Taxpayer:	Stephen & Harriet Ziegler		07/01/2004
Identification Number:	062-28-0530	Total	4.00.00

1996 - SCHEDULE D - CAPITAL GAINS AND LOSSES

1. Short-term capital gain or loss	(2,912.00)
2. Short-term capital loss carryover	0.00
3. Net Short-term Gain or Loss (Add line 1 and 2)	(2,912.00)
4. Long-term capital gain or loss	43,517.00
5. Long-term capital loss carryover	0.00
6. Net long-term Gain or Loss (Add line 4 and 5)	43,517.00
7. Sum of lines 3 and 6 - Net Capital Gain or Loss	40,605.00
8. Capital loss limitation	0.00
9. Capital Gain or Loss - As Corrected	40,605.00
10. Capital Gain or Loss - Per Return	40,605.00
11. Line 9 less line 10 - Adjustment to Income	0.00

CORRECTED CARRYOVER

12. Short-term Carryover to Subsequent Year	0.00
13. Long-term Carryover to Subsequent Year	0.00

COMPUTATION OF ALTERNATIVE TAX

14. Taxable Income	174,715.00
15. Lesser of Long-Term Gain or Net Capital Gain	39,466.00
16. Form 4952, line e	1,139.00
17. Line 15 less line 16	39,466.00
18. Line 14 less line 17	135,249.00
19. Alternative amount based on filing status	40,100.00
20. Greater of line 18 or line 19	135,249.00
21. Line 14 less line 20	39,466.00
22. Tax on line 20 using R	33,807.00
23. Line 21 multiplied by 28%	11,050.00
24. Line 22 plus line 23 - Alternative Capital Gain Tax	44,857.00

Schedule 7

Name of Taxpayer: Stephen & Harriet Ziegler		07/01/2004
Identification Number: 062-28-0530	Total	4.00.00

1997 - SCHEDULE D - CAPITAL GAINS AND LOSSES

1. Short-term capital gain or loss	3,431.00
2. Short-term capital loss carryover	0.00
3. Net Short-term Gain or Loss (Add line 1 and 2)	3,431.00
4. Long-term capital gain or loss	6,947.00
5. Long-term capital gain or loss carryover	0.00
6. Net long-term Gain or Loss (Add line 4 and 5)	6,947.00
7. Sum of lines 3 and 6 - Net Capital Gain or Loss	10,378.00
8. Capital loss limitation	0.00
9. Capital Gain or Loss - As Corrected	10,378.00
10. Capital Gain or Loss - Per Return	10,378.00
11. Line 9 less line 10 - Adjustment to Income	0.00
CORRECTED CARRYOVER	
12. Short-term Carryover to Subsequent Year	0.00
13. Long-term Carryover to Subsequent Year	0.00
COMPUTATION OF ALTERNATE TAX	
14. Taxable Income	219,125.00
15. Smaller of line 6 or line 7	6,947.00
16. Form 4952, line 4e	0.00
17. Subtract line 16 from line 15	6,947.00
18. Combine line 3 and Total 28% Rate Gain (not less than 0)	4,525.00
19. Smaller of line 18 and Total 28% Rate Gain	1,094.00
20. Unrecaptured Section 1250 Gain	0.00
21. Add line 19 and 20	1,094.00
22. Subtract line 21 from line 17 (not less than 0)	5,853.00
23. Subtract line 22 from line 14 (not less than 0)	213,272.00
24. Smaller of line 14 or 41,200.00	41,200.00
25. Smaller of line 23 or line 24	41,200.00
26. Subtract line 17 from line 14 (not less than 0)	212,178.00
27. Larger of line 25 or line 26	212,178.00
28. Tax on amount on line 27	60,453.00
29. Amount from line 24	41,200.00
30. Amount from line 23	213,272.00
31. Subtract line 30 from line 29 (not less than 0)	0.00
32. Multiply line 31 by 10%	0.00
33. Smaller of line 14 or line 22	5,853.00
34. Amount from line 31	0.00
35. Subtract line 34 from line 33 (not less than 0)	5,853.00
36. Multiply line 35 by 20%	1,171.00
37. Smaller of line 17 or line 20	0.00
38. Add lines 17 and 27	219,125.00
39. Amount from line 14	219,125.00
40. Subtract line 39 from line 38	0.00
41. Subtract line 40 from line 37	0.00
42. Multiply line 41 by 25%	0.00
43. Amount from line 14	219,125.00
44. Add lines 27, 31, 35, and 41	218,031.00
45. Subtract line 44 from line 43	1,094.00
46. Multiply line 45 by 28%	306.00
47. Add lines 28, 32, 36, 42, and 46 - Alternative Tax	61,930.00

Schedule

Name of Taxpayer: Stephen & Harriet Ziegler
Identification Number: 062-28-0530

	Total	07/01/2004
		4.00.00

1998 - SCHEDULE D - CAPITAL GAINS AND LOSSES

1. Short-term capital gain or loss	1,942.00
2. Short-term capital loss carryover	0.00
3. Net Short-term Gain or Loss (Add line 1 and 2)	1,942.00
4. Long-term capital gain or loss	5,305.00
5. Long-term capital gain or loss carryover	0.00
6. Net long-term Gain or Loss (Add line 4 and 5)	5,305.00
7. Sum of lines 3 and 6 - Net Capital Gain or Loss	7,247.00
8. Capital loss limitation	0.00
9. Capital Gain or Loss - As Corrected	7,247.00
10. Capital Gain or Loss - Per Return	7,247.00
11. Line 9 less line 10 - Adjustment to Income	0.00
CORRECTED CARRYOVER	
12. Short-term Carryover to Subsequent Year	0.00
13. Long-term Carryover to Subsequent Year	0.00
COMPUTATION OF ALTERNATE TAX	
14. Taxable Income	303,864.00
15. Smaller of line 6 or line 7	5,305.00
16. Form 4952, line 4e	1,166.00
17. Subtract line 16 from line 15	4,139.00
18. Combine line 3 and Total 28% Rate Gain (not less than 0)	1,942.00
19. Smaller of line 18 and Total 28% Rate Gain	0.00
20. Unrecaptured Section 1250 Gain	0.00
21. Add line 19 and 20	0.00
22. Subtract line 21 from line 17 (not less than 0)	4,139.00
23. Subtract line 22 from line 14 (not less than 0)	299,725.00
24. Smaller of line 14 or 42,350.00	42,350.00
25. Smaller of line 23 or line 24	42,350.00
26. Subtract line 17 from line 14 (not less than 0)	299,725.00
27. Larger of line 25 or line 26	299,725.00
28. Tax on amount on line 27	92,295.00
29. Amount from line 24	42,350.00
30. Amount from line 23	299,725.00
31. Subtract line 30 from line 29 (not less than 0)	0.00
32. Multiply line 31 by 10%	0.00
33. Smaller of line 14 or line 22	4,139.00
34. Amount from line 31	0.00
35. Subtract line 34 from line 33 (not less than 0)	4,139.00
36. Multiply line 35 by 20%	828.00
37. Smaller of line 17 or line 20	0.00
38. Add lines 17 and 27	303,864.00
39. Amount from line 14	303,864.00
40. Subtract line 39 from line 38	0.00
41. Subtract line 40 from line 37	0.00
42. Multiply line 41 by 25%	0.00
43. Amount from line 14	303,864.00
44. Add lines 27, 31, 35, and 41	303,864.00
45. Subtract line 44 from line 43	0.00
46. Multiply line 45 by 28%	0.00
47. Add lines 28, 32, 36, 42, and 46 - Alternative Tax	93,123.00

Schedule 9

Name of Taxpayer: Stephen & Harriet Ziegler		07/01/2004
Identification Number: 062-28-0530	Total	4.00.00

1999 - SCHEDULE D - CAPITAL GAINS AND LOSSES

1. Short-term capital gain or loss	(1,184.00)
2. Short-term capital loss carryover	0.00
3. Net Short-term Gain or Loss (Add line 1 and 2)	(1,184.00)
4. Long-term capital gain or loss	2,609.00
5. Long-term capital gain or loss carryover	0.00
6. Net long-term Gain or Loss (Add line 4 and 5)	2,609.00
7. Sum of lines 3 and 6 - Net Capital Gain or Loss	1,425.00
8. Capital loss limitation	0.00
9. Capital Gain or Loss - As Corrected	1,425.00
10. Capital Gain or Loss - Per Return	1,425.00
11. Line 9 less line 10 - Adjustment to Income	0.00
CORRECTED CARRYOVER	
12. Short-term Carryover to Subsequent Year	0.00
13. Long-term Carryover to Subsequent Year	0.00
COMPUTATION OF ALTERNATE TAX	
14. Taxable Income	317,301.00
15. Smaller of line 6 or line 7	1,425.00
16. Form 4952, line 4e	1,425.00
17. Subtract line 16 from line 15	0.00
18. Combine line 3 and Total 28% Rate Gain (not less than 0)	0.00
19. Smaller of line 18 and Total 28% Rate Gain	0.00
20. Unrecaptured Section 1250 Gain	0.00
21. Add line 19 and 20	0.00
22. Subtract line 21 from line 17 (not less than 0)	0.00
23. Subtract line 22 from line 14 (not less than 0)	317,301.00
24. Smaller of line 14 or 43,050.00	43,050.00
25. Smaller of line 23 or line 24	43,050.00
26. Subtract line 17 from line 14 (not less than 0)	317,301.00
27. Larger of line 25 or line 26	317,301.00
28. Tax on amount on line 27	98,812.00
29. Amount from line 24	43,050.00
30. Amount from line 23	317,301.00
31. Subtract line 30 from line 29 (not less than 0)	0.00
32. Multiply line 31 by 10%	0.00
33. Smaller of line 14 or line 22	0.00
34. Amount from line 31	0.00
35. Subtract line 34 from line 33 (not less than 0)	0.00
36. Multiply line 35 by 20%	0.00
37. Smaller of line 17 or line 20	0.00
38. Add lines 17 and 27	317,301.00
39. Amount from line 14	317,301.00
40. Subtract line 39 from line 38	0.00
41. Subtract line 40 from line 37	0.00
42. Multiply line 41 by 25%	0.00
43. Amount from line 14	317,301.00
44. Add lines 27, 31, 35, and 41	317,301.00
45. Subtract line 44 from line 43	0.00
46. Multiply line 45 by 28%	0.00
47. Add lines 28, 32, 36, 42, and 46 - Alternative Tax	98,812.00

Schedule 10(a

Name of Taxpayer:	Stephen & Harriet Ziegler		07/01/2004
Identification Number:	062-28-0530	Total	4.00.00

SUMMARY OF THE ACCURACY-RELATED PENALTY

1995 - 20% PENALTY ISSUES - Section 6662(a) and 6662(b)

It has been determined that the underpayment of tax shown on line 5 below is attributable to one or more of the following elements of the accuracy-related penalty: (1) negligence or disregard of rules or regulations, (2) substantial understatement of income tax, or (3) substantial valuation overstatement, therefore, an addition to tax is imposed as provided by Section 6662(a) of the Internal Revenue Code.

1. Total tax computed with non-penalty adjustments and adjustments subject to penalty under Section 6662(b)	95,294.00
2. Total tax computed with non-penalty adjustments only	83,751.00
3. Line 1 less line 2 - Underpayment to which Section 6662(a) applies	11,543.00
4. Allocable Prepayment Credits (other than EIC and Special Fuels Credits included in lines 1 & 2)	0.00
5. Line 3 less line 4 - Underpayment subject to penalty	11,543.00
6. Applicable penalty rate	20.00%
7. Line 5 multiplied by line 6	2,308.60
8. Previously assessed 20% Accuracy Penalty	0.00
9. Line 7 less line 8 - 20% Accuracy-related penalty	2,308.60

1995 - 40% PENALTY ISSUES - Section 6662(h)

It has been determined that the underpayment of tax shown on line 14 below is attributable to a gross valuation misstatement, therefore, an addition to tax is imposed as provided by Section 6662(h) of the Internal Revenue Code.

10. Total tax computed with non-penalty adjustments, adjustments subject to penalty under IRC 6662(a) and adjustments subject to penalty under IRC 6662(h)	95,294.00
11. Total tax from line 1 above	95,294.00
12. Line 10 less line 11 - Underpayment to which Section 6662(h) applies	0.00
13. Allocable Prepayment Credits (other than EIC and Special Fuels Credits included in lines 10 & 11)	0.00
14. Line 10 less line 11 - Underpayment subject to penalty	0.00
15. Applicable penalty rate	0.00%
16. Line 14 multiplied by line 15	0.00
17. Previously assessed 40% Accuracy Penalty	0.00
18. Line 16 less line 17 - 40% Accuracy-related penalty	0.00
19. Line 9 plus line 18 - Total ACCURACY-RELATED PENALTY	2,308.60

Schedule 1(E

Name Of Taxpayer:	Stephen & Harriet Ziegler		07/01/2004
Identification Number:	062-28-0530	Total	4.00.00

1995 - ACCURACY RELATED PENALTY-SECTION 6662(A) AND 6662(H) (CONTINUED)

ADJUSTMENTS TO WHICH THE ACCURACY RELATED PENALTY APPLIES:

	PENALTY RATES 20%	40%		
Sch E - passive loss, Aldus Green Asso.	X		44,108.00	IRC 6662(c)

Schedule 11

49a

Name of Taxpayer:	Stephen & Harriet Ziegler		07/01/2004
Identification Number:	062-28-0530	Total	4.00.00

SUMMARY OF THE ACCURACY-RELATED PENALTY

1996 - 20% PENALTY ISSUES - Section 6662(a) and 6662(b)

It has been determined that the underpayment of tax shown on line 5 below is attributable to one or more of the following elements of the accuracy-related penalty: (1) negligence or disregard of rules or regulations, (2) substantial understatement of income tax, or (3) substantial valuation overstatement, therefore, an addition to tax is imposed as provided by Section 6662(a) of the Internal Revenue Code.

1. Total tax computed with non-penalty adjustments and adjustments subject to penalty under Section 6662(b)	12,050.00
2. Total tax computed with non-penalty adjustments only	0.00
3. Line 1 less line 2 - Underpayment to which Section 6662(a) applies	12,050.00
4. Allocable Prepayment Credits (other than EIC and Special Fuels Credits included in lines 1 & 2)	0.00
5. Line 3 less line 4 - Underpayment subject to penalty	12,050.00
6. Applicable penalty rate	20.00%
7. Line 5 multiplied by line 6	2,410.00
8. Previously assessed 20% Accuracy Penalty	0.00
9. Line 7 less line 8 - 20% Accuracy-related penalty	2,410.00

1996 - 40% PENALTY ISSUES - Section 6662(h)

It has been determined that the underpayment of tax shown on line 14 below is attributable to a gross valuation misstatement, therefore, an addition to tax is imposed as provided by Section 6662(h) of the Internal Revenue Code.

10. Total tax computed with non-penalty adjustments, adjustments subject to penalty under IRC 6662(a) and adjustments subject to penalty under IRC 6662(h)	0.00
11. Total tax from line 1 above	12,050.00
12. Line 10 less line 11 - Underpayment to which Section 6662(h) applies	0.00
13. Allocable Prepayment Credits (other than EIC and Special Fuels Credits included in lines 10 & 11)	0.00
14. Line 10 less line 11 - Underpayment subject to penalty	0.00
15. Applicable penalty rate	0.00%
16. Line 14 multiplied by line 15	0.00
17. Previously assessed 40% Accuracy Penalty	0.00
18. Line 16 less line 17 - 40% Accuracy-related penalty	0.00
19. Line 9 plus line 18 - Total ACCURACY-RELATED PENALTY	2,410.00

Schedule 12

Name of Taxpayer:	Stephen & Harriet Ziegler		07/01/2004
Identification Number:	062-28-0530	Total	4.00 00

SUMMARY OF THE ACCURACY-RELATED PENALTY

1997 - 20% PENALTY ISSUES - Section 6662(a) and 6662(b)

It has been determined that the underpayment of tax shown on line 5 below is attributable to one or more of the following elements of the accuracy-related penalty: (1) negligence or disregard of rules or regulations, (2) substantial understatement of income tax, or (3) substantial valuation overstatement, therefore, an addition to tax is imposed as provided by Section 6662(a) of the Internal Revenue Code..

1. Total tax computed with non-penalty adjustments and adjustments subject to penalty under Section 6662(b)	28,819.00
2. Total tax computed with non-penalty adjustments only	0.00
3. Line 1 less line 2 - Underpayment to which Section 6662(a) applies	28,819.00
4. Allocable Prepayment Credits (other than EIC and Special Fuels Credits included in lines 1 & 2)	0.00
5. Line 3 less line 4 - Underpayment subject to penalty	28,819.00
6. Applicable penalty rate	20.00%
7. Line 5 multiplied by line 6	5,763.80
8. Previously assessed 20% Accuracy Penalty	0.00
9. Line 7 less line 8 - 20% Accuracy-related penalty	5,763.80

1997 - 40% PENALTY ISSUES - Section 6662(h)

It has been determined that the underpayment of tax shown on line 14 below is attributable to a gross valuation misstatement, therefore, an addition to tax is imposed as provided by Section 6662(h) of the Internal Revenue Code.

10. Total tax computed with non-penalty adjustments, adjustments subject to penalty under IRC 6662(a) and adjustments subject to penalty under IRC 6662(h)	0.00
11. Total tax from line 1 above	28,819.00
12. Line 10 less line 11 - Underpayment to which Section 6662(h) applies	0.00
13. Allocable Prepayment Credits (other than EIC and Special Fuels Credits included in lines 10 & 11)	0.00
14. Line 10 less line 11 - Underpayment subject to penalty	0.00
15. Applicable penalty rate	0.00%
16. Line 14 multiplied by line 15	0.00
17. Previously assessed 40% Accuracy Penalty	0.00
18. Line 16 less line 17 - 40% Accuracy-related penalty	0.00
19. Line 9 plus line 18 - Total ACCURACY-RELATED PENALTY	5,763.80

Schedule 13

Name of Taxpayer:	Stephen & Harriet Ziegler		07/01/2004
Identification Number:	062-28-0530	Total	4.00.00

SUMMARY OF THE ACCURACY-RELATED PENALTY

1998 - 20% PENALTY ISSUES - Section 6662(a) and 6662(b)

It has been determined that the underpayment of tax shown on line 5 below is attributable to one or more of the following elements of the accuracy-related penalty: (1) negligence or disregard of rules or regulations, (2) substantial understatement of income tax, or (3) substantial valuation overstatement, therefore, an addition to tax is imposed as provided by Section 6662(a) of the Internal Revenue Code.

1. Total tax computed with non-penalty adjustments and adjustments subject to penalty under Section 6662(b)	16,671.00
2. Total tax computed with non-penalty adjustments only	0.00
3. Line 1 less line 2 - Underpayment to which Section 6662(a) applies	16,671.00
4. Allocable Prepayment Credits (other than EIC and Special Fuels Credits included in lines 1 & 2)	0.00
5. Line 3 less line 4 - Underpayment subject to penalty	16,671.00
6. Applicable penalty rate	20.00%
7. Line 5 multiplied by line 6	3,334.20
8. Previously assessed 20% Accuracy Penalty	0.00
9. Line 7 less line 8 - 20% Accuracy-related penalty	3,334.20

1998 - 40% PENALTY ISSUES - Section 6662(h)

It has been determined that the underpayment of tax shown on line 14 below is attributable to a gross valuation misstatement, therefore, an addition to tax is imposed as provided by Section 6662(h) of the Internal Revenue Code.

10. Total tax computed with non-penalty adjustments, adjustments subject to penalty under IRC 6662(a) and adjustments subject to penalty under IRC 6662(h)	0.00
11. Total tax from line 1 above	16,671.00
12. Line 10 less line 11 - Underpayment to which Section 6662(h) applies	0.00
13. Allocable Prepayment Credits (other than EIC and Special Fuels Credits included in lines 10 & 11)	0.00
14. Line 10 less line 11 - Underpayment subject to penalty	0.00
15. Applicable penalty rate	0.00%
16. Line 14 multiplied by line 15	0.00
17. Previously assessed 40% Accuracy Penalty	0.00
18. Line 16 less line 17 - 40% Accuracy-related penalty	0.00
19. Line 9 plus line 18 - Total ACCURACY-RELATED PENALTY	3,334.20

Schedule 14

Name of Taxpayer:	Stephen & Harriet Ziegler		07/01/2004
Identification Number:	062-28-0530	Total	4.00.00

SUMMARY OF THE ACCURACY-RELATED PENALTY

1999 - 20% PENALTY ISSUES - Section 6662(a) and 6662(b)

It has been determined that the underpayment of tax shown on line 5 below is attributable to one or more of the following elements of the accuracy-related penalty: (1) negligence or disregard of rules or regulations, (2) substantial understatement of income tax, or (3) substantial valuation overstatement, therefore, an addition to tax is imposed as provided by Section 6662(a) of the Internal Revenue Code.

1. Total tax computed with non-penalty adjustments and adjustments subject to penalty under Section 6662(b)	19,665.00
2. Total tax computed with non-penalty adjustments only	0.00
3. Line 1 less line 2 - Underpayment to which Section 6662(a) applies	19,665.00
4. Allocable Prepayment Credits (other than EIC and Special Fuels Credits included in lines 1 & 2)	0.00
5. Line 3 less line 4 - Underpayment subject to penalty	19,665.00
6. Applicable penalty rate	20.00%
7. Line 5 multiplied by line 6	3,933.00
8. Previously assessed 20% Accuracy Penalty	0.00
9. Line 7 less line 8 - 20% Accuracy-related penalty	3,933.00

1999 - 40% PENALTY ISSUES - Section 6662(h)

It has been determined that the underpayment of tax shown on line 14 below is attributable to a gross valuation misstatement, therefore, an addition to tax is imposed as provided by Section 6662(h) of the Internal Revenue Code.

10. Total tax computed with non-penalty adjustments, adjustments subject to penalty under IRC 6662(a) and adjustments subject to penalty under IRC 6662(h)	0.00
11. Total tax from line 1 above	19,665.00
12. Line 10 less line 11 - Underpayment to which Section 6662(h) applies	0.00
13. Allocable Prepayment Credits (other than EIC and Special Fuels Credits included in lines 10 & 11)	0.00
14. Line 10 less line 11 - Underpayment subject to penalty	0.00
15. Applicable penalty rate	0.00%
16. Line 14 multiplied by line 15	0.00
17. Previously assessed 40% Accuracy Penalty	0.00
18. Line 16 less line 17 - 40% Accuracy-related penalty	0.00
19. Line 9 plus line 18 - Total ACCURACY-RELATED PENALTY	3,933.00

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Sdedule 15

Name of Taxpayer: Stephen & Harriet Ziegler
Identification Number: 062-28-0530

Total		07/01/2004
		4,00.00

EXPLANATION OF THE DELINQUENCY PENALTY

Since your income tax return was not filed within the time limit prescribed by law and/or the tax was not paid, and you have not shown that such failure was due to reasonable cause, an addition to the tax is charged as shown below, in accordance with Section 6651(a)(1) and/or Section 6651(a)(2) of the Internal Revenue Code.

1996 - DELINQUENCY PENALTY

1. Delinquency penalty abated		0.00
2. Date return due	10/15/1997	
3. Date return filed	11/10/1997	
4. Failure to File penalty rate	0.050	
5. Failure to Pay penalty rate	0.000	
6. Total corrected tax, Form 4549, line 11		44,857.00
7. Payments on or prior to due date of return		21,770.00
8. Line 6 less line 7		23,087.00
9. Failure to File Penalty - line 8 multiplied by line 4		1,154.35
10. Minimum penalty if over 60 days delinquent		0.00
11. Failure to File Penalty - Greater of line 9 or line 10		1,154.35
12. Previously assessed Failure to File Penalty		552.00
13. Net Failure to File Penalty - line 11 less line 12		602.35
14. Failure to Pay Penalty - line 8 multiplied by line 5		0.00
15. Previously assessed Failure to Pay Penalty		0.00
16. Net Failure to Pay Penalty - line 14 less line 15		0.00
17. Total Delinquency Penalty - Sum of line 13 and 16		602.35

- If an amount appears as the Failure to Pay Penalty, the amount only reflects the addition to tax under Internal Revenue Code section 6651(a)(2) through the date of this notice. The addition to tax will continue to accrue from the due date of the return at a rate of 0.5 percent each month, or fraction thereof, of nonpayment, not exceeding 25 percent.

EXHIBIT E

PASSIVE LOSS LIMITATION UNDER 26 U.S.C. § 469

Effective: January 01, 2005
United States Code Annotated Currentness
Title 26. Internal Revenue Code
Subtitle A. Income Taxes
Chapter 1. Normal Taxes and Surtaxes
Subchapter E. Accounting Periods and Methods of Accounting
Part II. Methods of Accounting
Subpart C. Taxable Year for Which Deductions Taken

469. Passive activity losses and credits limited

(a) Disallowance.—

(1) In general.—If for any taxable year the taxpayer is described in paragraph (2), neither—

(A) the passive activity loss, nor

(B) the passive activity credit,

for the taxable year shall be allowed.

(2) Persons described.—The following are described in this paragraph:

(A) any individual, estate, or trust,

(B) any closely held C corporation, and

(C) any personal service corporation.

(b) Disallowed loss or credit carried to next year.—Except as otherwise provided in this section, any loss or credit from an activity which is disallowed under subsection (a) shall be treated as a deduction or

credit allocable to such activity in the next taxable year.

(c) Passive activity defined.—For purposes of this section—

(1) In general.—The term "passive activity" means any activity—

(A) which involves the conduct of any trade or business, and

(B) in which the taxpayer does not materially participate.

(2) Passive activity includes any rental activity.—Except as provided in paragraph (7), the term "passive activity" includes any rental activity.

(3) Working interests in oil and gas property.—

(A) In general.—The term "passive activity" shall not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest.

(B) Income in subsequent years.—If any taxpayer has any loss for any taxable year from a working interest in any oil or gas property which is treated as a loss which is not from a passive activity, then any net income from such property (or any property the basis of which is determined in whole or in part by reference to the basis of such property) for any succeeding taxable year shall be treated as income of the taxpayer which is not from a passive activity. If the preceding sentence applies to the net income from any property for

any taxable year, any credits allowable under subpart B (other than section 27(a)) or D of part IV of subchapter A for such taxable year which are attributable to such property shall be treated as credits not from a passive activity to the extent the amount of such credits does not exceed the regular tax liability of the taxpayer for the taxable year which is allocable to such net income.

(4) Material participation not required for paragraphs (2) and (3).—Paragraphs (2) and (3) shall be applied without regard to whether or not the taxpayer materially participates in the activity.

(5) Trade or business includes research and experimentation activity.—For purposes of paragraph (1)(A), the term "trade or business" includes any activity involving research or experimentation (within the meaning of section 174).

(6) Activity in connection with trade or business or production of income.—To the extent provided in regulations, for purposes of paragraph (1)(A), the term "trade or business" includes—

(A) any activity in connection with a trade or business, or

(B) any activity with respect to which expenses are allowable as a deduction under section 212.

(7) Special rules for taxpayers in real property business.—

(A) In general.—If this paragraph applies to any taxpayer for a taxable year—

(i) paragraph (2) shall not apply to any rental real estate activity of such taxpayer for such taxable year, and

(ii) this section shall be applied as if each interest of the taxpayer in rental real estate were a separate activity.

Notwithstanding clause (ii), a taxpayer may elect to treat all interests in rental real estate as one activity. Nothing in the preceding provisions of this subparagraph shall be construed as affecting the determination of whether the taxpayer materially participates with respect to any interest in a limited partnership as a limited partner.

(B) Taxpayers to whom paragraph applies.—This paragraph shall apply to a taxpayer for a taxable year if—

(i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and

(ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

In the case of a joint return, the requirements of the preceding sentence are satisfied if and only if either spouse separately satisfies such requirements. For purposes of the preceding sentence, activities in

which a spouse materially participates shall be determined under subsection (h).

(C) Real property trade or business.—For purposes of this paragraph, the term "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

(D) Special rules for subparagraph (B).—

(i) Closely held C corporations.—In the case of a closely held C corporation, the requirements of subparagraph (B) shall be treated as met for any taxable year if more than 50 percent of the gross receipts of such corporation for such taxable year are derived from real property trades or businesses in which the corporation materially participates.

(ii) Personal services as an employee.—For purposes of subparagraph (B), personal services performed as an employee shall not be treated as performed in real property trades or businesses. The preceding sentence shall not apply if such employee is a 5-percent owner (as defined in section 416(i)(1)(B)) in the employer.

(d) Passive activity loss and credit defined.—For purposes of this section—

(1) Passive activity loss.—The term "passive activity loss" means the amount (if any) by which—

(A) the aggregate losses from all passive activities for the taxable year, exceed

(B) the aggregate income from all passive activities for such year.

(2) Passive activity credit.—The term "passive activity credit" means the amount (if any) by which—

(A) the sum of the credits from all passive activities allowable for the taxable year under—

(i) subpart D of part IV of subchapter A, or

(ii) subpart B (other than section 270) of such part IV, exceeds

(B) the regular tax liability of the taxpayer for the taxable year allocable to all passive activities.

(e) Special rules for determining income or loss from a passive activity.—For purposes of this section—

(1) Certain income not treated as income from passive activity.—In determining the income or loss from any activity—

(A) In general.—There shall not be taken into account—

(i) any—

(I) gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business,

(II) expenses (other than interest) which are clearly and directly allocable to such gross income, and

(III) interest expense properly allocable to such gross income, and

(ii) gain or loss not derived in the ordinary course of a trade or business which is attributable to the disposition of property—

(I) producing income of a type described in clause (i), or

(II) held for investment.

For purposes of clause (ii), any interest in a passive activity shall not be treated as property held for investment.

(B) Return on working capital.—For purposes of subparagraph (A), any income, gain, or loss which is attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business.

(2) Passive losses of certain closely held corporations may offset active income.—

(A) In general.—If a closely held C corporation (other than a personal service corporation) has net active income for any taxable year, the passive activity loss of such taxpayer for such taxable year (determined without regard to this paragraph)—

(i) shall be allowable as a deduction against net active income, and

(ii) shall not be taken into account under subsection (a) to the extent so allowable as a deduction. A similar rule shall apply in the case of any passive activity credit of the taxpayer.

(B) Net active income.—For purposes of this paragraph, the term "net active income" means the taxable income of the taxpayer for the taxable year determined without regard to—

(i) any income or loss from a passive activity, and

(ii) any item of gross income, expense, gain, or loss described in paragraph (1)(A).

(3) Compensation for personal services.—Earned income (within the meaning of section 911(d)(2)(A)) shall not be taken into account in computing the income or loss from a passive activity for any taxable year.

(4) Dividends reduced by dividends received deduction.—For purposes of paragraphs (1) and (2), income from dividends shall be reduced by the amount of any dividends received deduction under section 243, 244, or 245.

(f) Treatment of former passive activities.—For purposes of this section—

(1) In general.—If an activity is a former passive activity for any taxable year—

(A) any unused deduction allocable to such activity under subsection (b) shall be offset against the income from such activity for the taxable year,

(B) any unused credit allocable to such activity under subsection (b) shall be offset against the regular tax liability (computed after the application of paragraph (1)) allocable to such activity for the taxable year, and

(C) any such deduction or credit remaining after the application of subparagraphs (A) and

(B) shall continue to be treated as arising from a passive activity.

(2) Change in status of closely held C corporation or personal service corporation.—If a taxpayer ceases for any taxable year to be a closely held C corporation or personal service corporation, this section shall continue to apply to losses and credits to which this section applied for any preceding taxable year in the same manner as if such taxpayer continued to be a closely held C corporation or personal service corporation, whichever is applicable.

(3) Former passive activity.—The term "former passive activity" means any activity which, with respect to the taxpayer—

(A) is not a passive activity for the taxable year, but

(B) was a passive activity for any prior taxable year.

(g) Dispositions of entire interest in passive activity.—If during the taxable year a taxpayer disposes of his entire interest in any passive activity (or former passive activity), the following rules shall apply:

(1) Fully taxable transaction.—

(A) In general.—If all gain or loss realized on such disposition is recognized, the excess of—

(i) any loss from such activity for such taxable year (determined after the application of subsection (b)), over

(ii) any net income or gain for such taxable year from all other passive activities (determined after the application of subsection (b)),

shall be treated as a loss which is not from a passive activity.

(B) Subparagraph (A) not to apply to disposition involving related party.—If the taxpayer and the person acquiring the interest bear a relationship to each other described in section 267(b) or section 707(b)(1), then subparagraph (A) shall not apply to any loss of the taxpayer until the taxable year in which such interest is acquired (in a transaction described in subparagraph (A)) by another person who does not bear such a relationship to the taxpayer.

(C) Income from prior years.—To the extent provided in regulations, income or gain from the activity for preceding taxable years shall be taken into account under subparagraph (A)(ii) for the taxable year to the extent necessary to prevent the avoidance of this section.

(2) Disposition by death.—If an interest in the activity is transferred by reason of the death of the taxpayer—

(A) paragraph (1)(A) shall apply to losses described in paragraph (1)(A) to the extent such losses are greater than the excess (if any) of—

(i) the basis of such property in the hands of the transferee, over

(ii) the adjusted basis of such property immediately before the death of the taxpayer, and

(B) any losses to the extent of the excess described in subparagraph (A) shall not be allowed as a deduction for any taxable year.

(3) Installment sale of entire interest.—In the case of an installment sale of an entire interest in an activity to which section 453 applies, paragraph (1) shall apply to the portion of such losses for each taxable year which bears the same ratio to all such losses as the gain recognized on such sale during such taxable year bears to the gross profit from such sale (realized or to be realized when payment is completed).

(h) Material participation defined.—For purposes of this section—

(1) In general.—A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is—

(A) regular,

(B) continuous, and

(C) substantial.

(2) Interests in limited partnerships.—Except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.

(3) Treatment of certain retired individuals and surviving spouses.—A taxpayer shall be treated as materially participating in any farming activity for a taxable year if paragraph (4) or (5) of section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with

respect to real property used in such activity if such taxpayer had died during the taxable year.

(4) Certain closely held C corporations and personal service corporations.—A closely held C corporation or personal service corporation shall be treated as materially participating in an activity only if—

(A) 1 or more shareholders holding stock representing more than 50 percent (by value) of the outstanding stock of such corporation materially participate in such activity, or

(B) in the case of a closely held C corporation (other than a personal service corporation), the requirements of section 465(c)(7)(C) (without regard to clause (iv)) are met with respect to such activity.

(5) Participation by spouse.—In determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer shall be taken into account.

(i) $25,000 offset for rental real estate activities.—

(1) In general.—In the case of any natural person, subsection (a) shall not apply to that portion of the passive activity loss or the deduction equivalent (within the meaning of subsection (j)(5)) of the passive activity credit for any taxable year which is attributable to all rental real estate activities with respect to which such individual actively participated in such taxable year (and if any portion of such loss or credit arose in another taxable year, in such other taxable year).

(2) Dollar limitation.—The aggregate amount to which paragraph (1) applies for any taxable year shall not exceed $25,000.

(3) Phase-out of exemption.—

(A) In general.—In the case of any taxpayer, the $25,000 amount under paragraph (2) shall be reduced (but not below zero) by 50 percent of the amount by which the adjusted gross income of the taxpayer for the taxable year exceeds $100,000.

(B) Special phase-out of rehabilitation credit—In the case of any portion of the passive activity credit for any taxable year which is attributable to the rehabilitation credit determined under section 47, subparagraph (A) shall be applied by substituting 1200,000" for "$100,000".

(C) Exception for commercial revitalization deduction.—Subparagraph (A) shall not apply to any portion of the passive activity loss for any taxable year which is attributable to the commercial revitalization deduction under section 14001.

(D) Exception for low-income housing credit.—Subparagraph (A) shall not apply to any portion of the passive activity credit for any taxable year which is attributable to any credit determined under section 42.

(E) Ordering rules to reflect exceptions and separate phase-outs.—If subparagraph (B), (C), or (D) applies for a taxable year, paragraph (1) shall be applied—

(i) first to the portion of the passive activity loss to which subparagraph (C) does not apply,

(ii) second to the portion of such loss to which subparagraph (C) applies,

(iii) third to the portion of the passive activity credit to which subparagraph (B) or (D) does not apply,

(iv) fourth to the portion of such credit to which subparagraph (B) applies, and (v) then to the portion of such credit to which subparagraph (D) applies.

(F) Adjusted gross income.—For purposes of this paragraph, adjusted gross income shall be determined without regard to—

(i) any amount includible in gross income under section 86,

(ii) the amounts excludable from gross income under sections 135 and 137,

(iii) the amounts allowable as a deduction under sections 199, 219, 221, and 222, and

(iv) any passive activity loss or any loss allowable by reason of subsection (c)(7).

(4) Special rule for estates.—

(A) In general.—In the case of taxable years of an estate ending less than 2 years after the date of the death of the decedent, this subsection shall apply to all rental real estate activities with respect to which such decedent actively participated before his death.

(B) Reduction for surviving spouse's exemption.—For purposes of subparagraph (A), the $25,000 amount under paragraph (2) shall be reduced by the amount of the exemption under paragraph (1) (without regard to paragraph (3)) allowable to the surviving spouse of the decedent for the taxable year ending with or within the taxable year of the estate.

(5) Married individuals filing separately.—

(A) In general.—Except as provided in subparagraph (B), in the case of any married individual filing a separate return, this subsection shall be applied by substituting—

(i) 112,500" for "$25,000" each place it appears,

(ii) 150,000" for "$100,000" in paragraph (3)(A), and

(iii) "$100,000" for "$200,000" in paragraph (3)(B).

(B) Taxpayers not living apart.—This subsection shall not apply to a taxpayer who—

(i) is a married individual filing a separate return for any taxable year, and

(ii) does not live apart from his spouse at all times during such taxable year.

(6) Active participation.—

(A) In general.—An individual shall not be treated as actively participating with respect to any interest in any rental real estate activity for any period if, at any time during such period, such interest (including any interest of the spouse of the individual) is less

than 10 percent (by value) of all interests in such activity.

(B) No participation requirement for low-income housing, or rehabilitation credit, or commercial revitalization deduction.—Paragraphs (1) and (4)(A) shall be applied without regard to the active participation requirement in the case of—

(i) any credit determined under section 42 for any taxable year,

(ii) any rehabilitation credit determined under section 47, or.

(iii) any deduction under section 14001 (relating to commercial revitalization deduction).

(C) Interest as a limited partner.—Except as provided in regulations, no interest as a limited partner in a limited partnership shall be treated as an interest with respect to which the taxpayer actively participates.

(D) Participation by spouse.—In determining whether a taxpayer actively participates, the participation of the spouse of the taxpayer shall be taken into account.

(j) Other definitions and special rules.—For purposes of this section—

(1) Closely held C corporation.—The term "closely held C corporation" means any C corporation described in section 465(a)(1)(B).

(2) Personal service corporation.—The term "personal service corporation" has the meaning

given such term by section 269A(b)(1), except that section 269A(b)(2) shall be applied—

(A) by substituting "any" for "more than 10 percent", and

(B) by substituting "any" for "50 percent or more in value" in section 318(a)(2)(C).

A corporation shall not be treated as a personal service corporation unless more than 10 percent of the stock (by value) in such corporation is held by employee-owners (within the meaning of section 269A(b)(2), as modified by the preceding sentence).

(3) Regular tax liability.—The term "regular tax liability" has the meaning given such term by section 26(b).

(4) Allocation of passive activity loss and credit.—The passive activity loss and the passive activity credit (and the $25,000 amount under subsection (i)) shall be allocated to activities, and within activities, on a pro rata basis in such manner as the Secretary may prescribe.

(5) Deduction equivalent.—The deduction equivalent of credits from a passive activity for any taxable year is the amount which (if allowed as a deduction) would reduce the regular tax liability for such taxable year by an amount equal to such credits.

(6) Special rule for gifts.—In the case of a disposition of any interest in a passive activity by gift—

(A) the basis of such interest immediately before the transfer shall be increased by the amount of any passive activity losses allocable

to such interest with respect to which a deduction has not been allowed by reason of subsection (a), and

(B) such losses shall not be allowable as a deduction for any taxable year.

(7) Qualified residence interest.—The passive activity loss of a taxpayer shall be computed without regard to qualified residence interest (within the meaning of section 163(h)(3)).

(8) Rental activity.—The term "rental activity" means any activity where payments are principally for the use of tangible property.

(9) Election to increase basis of property by amount of disallowed credit.—For purposes of determining gain or loss from a disposition of any property to which subsection (g)(1) applies, the transferor may elect to increase the basis of such property immediately before the transfer by an amount equal to the portion of any unused credit allowable under this chapter which reduced the basis of such property for the taxable year in which such credit arose. If the taxpayer elects the application of this paragraph, such portion of the passive activity credit of such taxpayer shall not be allowed for any taxable year.

(10) Coordination with section 280A.—If a passive activity involves the use of a dwelling unit to which section 280A(c)(5) applies for any taxable year, any income, deduction, gain, or loss allocable to such use shall not be taken into account for purposes of this section for such taxable year.

(11) Aggregation of members of affiliated groups.—Except as provided in regulations, all

members of an affiliated group which files a consolidated return shall be treated as 1 corporation.

(12) Special rule for distributions by estates or trusts.—If any interest in a passive activity is distributed by an estate or trust—

(A) the basis of such interest immediately before such distribution shall be increased by the amount of any passive activity losses allocable to such interest, and

(B) such losses shall not be allowable as a deduction for any taxable year.

(k) Separate application of section in case of publicly traded partnerships.—

(1) In general.—This section shall be applied separately with respect to items attributable to each publicly traded partnership (and subsection (i) shall not apply with respect to items attributable to any such partnership). The preceding sentence shall not apply to any credit determined under section 42, or any rehabilitation credit determined under section 47, attributable to a publicly traded partnership to the extent the amount of any such credits exceeds the regular tax liability attributable to income from such partnership.

(2) Publicly traded partnership.—For purposes of this section, the term "publicly traded partnership" means any partnership if—

(A) interests in such partnership are traded on an established securities market, or

(B) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

(3) Coordination with subsection (g).—For purposes of subsection (g), a taxpayer shall not be treated as having disposed of his entire interest in an activity of a publicly traded partnership until he disposes of his entire interest in such partnership.

(4) Application to regulated investment companies.—For purposes of this section, a regulated investment company (as defined in section 851) holding an interest in a qualified publicly traded partnership (as defined in section 851(h)) shall be treated as a taxpayer described in subsection (a)(2) with respect to items attributable to such interest.

(I) Regulations.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of this section, including regulations—

(1) which specify what constitutes an activity, material participation, or active participation for purposes of this section,

(2) which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income),

(3) requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity,

(4) which provide for the determination of the allocation of interest expense for purposes of this section, and

(5) which deal with changes in marital status and changes between joint returns and separate returns.

(m) Phase-in of disallowance of losses and credits for interest held before date of enactment.—

(1) In general.—In the case of any passive activity loss or passive activity credit for any taxable year beginning in calendar years 1987 through 1990, subsection (a) shall not apply to the applicable percentage of that portion of such loss (or such credit) which is attributable to pre-enactment interests.

(2) Applicable percentage.—For purposes of this subsection, the applicable percentage shall be determined in accordance with the following table:

In the case of taxable years beginning in:	The applicable percentage is:
1987	65
1988	40
1989	20
1990	10

(3) Portion of loss or credit attributable to pre-enactment interests.—For purposes of this subsection—

(A) In general.—The portion of the passive activity loss (or passive activity credit) for any

taxable year which is attributable to pre-enactment interests is the lesser of—

(i) the amount of the passive activity loss (or passive activity credit) which is disallowed for the taxable year under subsection (a) (without regard to this subsection), or

(ii) the amount of the passive activity loss (or passive activity credit) which would be disallowed for the taxable year (without regard to this subsection and without regard to any amount allocable to an activity for the taxable year under subsection (b)) taking into account only pre- enactment interests.

(B) Pre-enactment interest.—

(i) In general.—The term "pre-enactment interest" means any interest in a passive activity held by a taxpayer on the date of the enactment of the Tax Reform Act of 1986, and at all times thereafter.

(ii) Binding contract exception.—For purposes of clause (i), any interest acquired after such date of enactment pursuant to a written binding contract in effect on such date, and at all times thereafter, shall be treated as held on such date.

(iii) Interest in activities.—The term "pre-enactment interest" shall not include an interest in a passive activity unless such activity was being conducted on such date of enactment. The preceding sentence shall not apply to an activity commencing after such date if—

(I) the property used in such activity is acquired pursuant to a written binding contract in effect on August 16, 1986, and at all times thereafter, or

(II) construction of property used in such activity began on or before August 16, 1986.

CREDIT(S)

(Added Pub.L. 99-514, Title V, § 501(a), Oct. 22, 1986, 100 Stat. 2233, and amended Pub.L. 100-203, Title X, § 10212(a), Dec. 22, 1987, 101 Stat. 1330- 405; Pub.L. 100-647, Title I, § 1005(a)(1) to (9), (11), (12), Title II, § 2004(g), Title VI, § 6009(c)(3), Nov. 10, 1988, 102 Stat. 3387, 3388, 3603, 3690; Pub.L. 101-239, Title VII § 7109(a), Dec. 12, 1989, 103 Stat. 2322; Pub.L. 101-508, Title XI, §§ 11704(a)(6), 11813(b)(16), Nov. 5, 1990, 104 Stat. 1388-518, 1388-555; Pub.L. 103-66 Title XIII, § 13143(a), (b), Aug. 10, 1993, 107 Stat. 440, 441; Pub.L. 104-188, Title I, §§ 1704(d)(1), (e)(1), 1807(c)(4), Aug. 20, 1996, 110 Stat. 1878, 1902; Pub.L. 105-277, Div. J, Title IV, § 4003(a)(2)(D), Oct. 21, 1998, 112 Stat. 2681-908; Pub.L. 106-554, § 1(a)(7) [Title I, § 101(b)], Dec. 21, 2000, 114 Stat. 2763, 2763A-599; Pub.L. 107-16, Title IV, § 431(c)(3), June 7, 2001, 115 Stat. 68; Pub.L. 107-147, Title IV, § 412(a), Mar. 9, 2002, 116 Stat. 53; Pub.L. 108-357, Title I, § 102(d)(5), Title III, 331(g), Oct. 22, 2004, 118 Stat. 1429, 1477.)

EXHIBIT F

TRANSITIONAL RULE FOR LOW-INCOME HOUSING
Pub. Law No. 99-514 § 502

UNITED STATES PUBLIC LAWS
99th Congress - Second Session
Convening January 21, 1986
PL 99-514 (HR 3838)
October 22, 1986

SEC. 502. TRANSITIONAL RULE FOR LOW-INCOME HOUSING.

(a) GENERAL RULE. — Any loss sustained by a qualified investor with respect to an interest in a qualified low-income housing project for any taxable year in the relief period shall not be treated as a loss from a passive activity for purposes of section 469 of the Internal Revenue Code of 1986.

(b) RELIEF PERIOD. — For purposes of subsection (a), the term "relief period" means the period beginning with the taxable year in which the investor made his initial investment in the qualified low-income housing project and ending with whichever of the following is the earliest—

(1) the 6th taxable year after the taxable year in which the investor made his initial investment,

(2) the 1st taxable year after the taxable year in which the investor is obligated to make his last investment, or

(3) the taxable year preceding the 1st taxable year for which such project ceased to be a qualified low-income housing project.

(c) QUALIFIED LOW-INCOME HOUSING PROJECT. — For purposes of this section, the term "qualified low-income housing project" means any project if—

(1) such project meets the requirements of clause (i), (ii), (iii), or (iv) of section 1250(a)(1)(B) as of the date placed in service and for each taxable year thereafter which begins after 1986 and for which a passive loss may be allowable with respect to such project,

(2) the operator certifies to the Secretary of the Treasury or his delegate that such project met the requirements of paragraph (1) on the date of the enactment of this Act (or, if later, when placed in service) and annually thereafter,

(3) such project is constructed or acquired pursuant to a binding written contract entered into on or before August 16, 1986, and

(4) such project is placed in service before January 1, 1989.

(d) QUALIFIED INVESTOR. — For purposes of this section—

(1) IN GENERAL. — The term "qualified investor" means any natural person who holds (directly or through 1 or more entities) an interest in a qualified low-income housing project—

(A) if—

(i) in the case of a project placed in service before August 16, 1986, such person held an interest in such project on August 16, 1986, and the taxpayer made his initial investment after December 31, 1983, or

(ii) in the case of a project not described in subparagraph (A), such investor held an interest in such project on December 31, 1986, and

(B) if such investor is required to make payments after December 31, 1986, of 50 percent or more of the total original obligated investment for such interest.

For purposes of subparagraph (A), a person shall be treated as holding an interest on August 16, 1986, or December 31, 1986, if on such date such person had a binding contract to acquire such interest.

(2) TREATMENT OF ESTATES. — The estate of a decedent shall succeed to the treatment under this section of the decedent but only with respect to the 1st 2 taxable years of such estate ending after the date of the decedent's death.

(d) SPECIAL RULES.—

(1) WHERE MORE THAN 1 BUILDING IN PROJECT. — If there is more than 1 building in any project, the determination of when such project is placed in service shall be based on when the 1st building in such project is placed in service.

(2) ONLY CASH AND OTHER PROPERTY TAKEN INTO ACCOUNT. — In determining the amount any person invests in (or is obligated to invest in) any interest, only cash and other property shall be taken into account.

(3) COORDINATION WITH CREDIT. — No low-income housing credit shall be determined under section 42 of the Internal Revenue Code of 1986 with respect to any project with respect to

which any person has been allowed any benefit under this section.

EXHIBIT G

CLOSING STATEMENT REGARDING STRUCTURE OF SELLER AND PARTNERSHIP AND PARTNERSHIP'S PURCHASE OF THE PROJECT

CLOSING STATEMENT

ALDUS GREEN COMPANY

This closing statement deals with:

- the sale as of November 30, 1984 (the "Closing Date") of the Aldus Green housing project by Aldus Green Associates ("Seller") to Aldus Green Company (the "Partnership"), and
- the financing of the purchase by the Partnership.

I. THE PARTNERSHIP/INITIAL PARTNERS

A. On February 2, 1984 (the "Formation Date"), the Partnership was formed as a New York general partnership. On February 27, 1984, the Partnership was reconstituted as a limited partnership pursuant to the filing of a Certificate of Limited Partnership in the New York County Clerk's office (the "Certificate").

B. From the Formation Date through November 30, 1984, the partners of the Partnership and their interests and contributions to the Partnership were as follows:

General Partner	Interest	Amount Contributed to the Partnership
Herman I. Kraus ("Kraus")	1%	$ 1.00
Limited Partner HIK Holding Corp. ("HIK")	99%	99.00
	100%	$100.00

C. HIK is a New York corporation all the issued and outstanding shares of which are owned by Kraus.

II. Seller

A. Seller was formed in 1974 as a New York limited partnership. Kraus is a general partner, holding a 1% interest. The limited partners are Kraus Enterprises, Inc. ("KEI"), an affiliate of Kraus (holding a 1% interest), and other persons unrelated to Kraus (holding a 98% interest). The limited partners other than KEI are referred to herein as "Seller's Investor Limited Partners."

The Investor Limited Partners were represented by the Aldus Street Committee ("ASC") consisting of Stanley Itskowitch, Martin J. Milston and Jacob Kantor, who were the professional representatives of almost all of the Investor Limited Partners.

In 1974-75, Seller acquired the properties located at 990, 995, 996, 999, 1,025 and 1,032 Aldus Street and 1,001, 1010, 1013, 1016, and 1017 Bryant Avenue, Bronx, New York.

After acquiring the properties, the Seller performed a gut rehabilitation on the buildings which was completed in August 1976. The properties as rehabilitated are hereinafter referred to as the "Project."

B. The Seller's development of the Project was financed by

(1) equity contributions from its partners in the amount of $2,940,000, and

(2) a First Mortgage in the amount of $12,377,300 (the "First Mortgage") made by the Thrift Associations Service Corporation ("TASCO") and insured by the United States Department of Housing and Urban Development ("HUD") under Section 221(d)(4) of the National Housing Act ("Section 221(d)(4)").

C. As of the Closing Date, the First Mortgage had an unpaid principal balance of $11,212,460. The First Mortgage bears interest at the rate of 8.5% per annum, matures on June 1, 2007, and requires monthly payments of principal and interest in the aggregate amount of $96,575 (in addition to escrow payments).

III Government Assistance

The terms of the sale can best be understood against the background of governmental regulation of the Project.

The following governmental regulations, among others, were applicable to Seller's holding of the Project and will be allocable to the Partnership's holding of the Project.

A. The Section 8 Contracts

A portion of the tenants' rentals are paid by assistance payments made by HUD under Section 8 of the United States Housing Act, as amended. Under Sec-

tion 8, in 1975, the following contracts (the "Section 8 Contracts") were entered into in regard to the Project by the Seller, HUD and DHCR.

(1) an Annual Contribution Contract (the "ACC") between HUD and DHCR,

(2) a Housing Assistance Payment Contract (the "HAPC"), and

(3) a Pledge Agreement in which the Seller granted to TASCO (the holder of the First Mortgage) as security' for the performance of all of the Seller's obligations under the First Mortgage, a security interest in all rights the Seller had under the HAPC.

The HAPC has an initial term of 5 years, plus 3 renewal terms of 5 years each at the owner's option. In the Pledge Agreement the Seller, DHCR and TASCO agreed to exercise all of these renewal terms. Hence, the HAPC has an aggregate term of 20 years ending on August 31, 1996.

The Section 8 Contracts (under which HUD pays approximately 85% of the tenants rents) are scheduled to terminate in 1996. The First Mortgage, however, will not be completely retired until 2007.

B. Regulation of Distributions by DHCR and HUD.

By virtue of the fact that HUD's ACC is with DHCR, the Seller is regulated by DHCR under Article 4 of the New York State Private Housing Finance Law ("PHFL").

Under Article 4, the owner of the Project is not permitted to make cash distributions to partners in excess of a cumulative rate of 6% of the Seller's eq-

uity as computed by DHCR.* DHCR computes the amount of the Seller's equity as $1,375,255, so that the maximum annual permissible distribution is approximately $82,515 per annum.* As of the Closing Date, the Seller had made aggregate distributions of approximately $660,120 representing the maximum amount Seller was authorized to distribute through said date under Article 4.

The balance of the Seller's cash flow was been retained by the Seller, and accordingly, as of the Closing Date, the Partnership had cash and investment balances of approximately $1,440,896.

These funds are in addition to the Seller's reserve for replacements. As of the Closing Date, the reserve for replacements had a balance of approximately $372,614, and the Project owner is required to make additions to the reserve of approximately $50,000 per annum. Subject to the approval of HUD and the mortgagee, the owner may make withdrawals from the reserve to pay for capital improvements and replacements.

Under Section 96 of Article 4, the owner of the project, cannot distribute its cash and investment

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* The Regulatory Agreement with HUD imposes an additional—but less restrictive—restriction on distributions. It provides that distributions can only be made from "surplus cash" which it defines as any cash remaining after the payment of (1) all sums currently due on the HUD insured First Mortgage, (2) all amounts required to be deposited in the Project's reserve for replacement, and (3) all other obligations of the Project for which funds for payment are not otherwise set aside.

* As stated below, to the extent that the Partnership's payments on the PM Mortgages described below exceed the payments coming due on the First Mortgage, they are treated as distributions for purposes of DHCR and HUD regulations.

balances to its partners until date 20 years after the occupancy of the Project, that is, approximately July 31, 1996.

By its terms, Section 96 conditions the right to make a distribution (which, in this case, would be the required July 31, 1996 payment on the PM Mortgages) upon (1) a dissolution of AGC, the limited dividend housing company (hereinafter discussed), and (2) payment of the balance due on the First Mortgage (which will be approximately $7,128,650 as of July 31, 1996). On the other hand, it may be argued that Section 81-3(a) of Article 4 gives DHCR the power to waive the prepayment' requirement. The latter Section provides that when a project is financed by a HUD insured mortgage loan, DHCR can authorize a capital structure for an Article 4 company which is not otherwise authorized by Article 4.

C. Role of the Limited Dividend Housing Company

Under Articles 2 and 3 of the PHFL, the New York State Housing Finance Agency is authorized to make mortgage loans—with the approval of DHCR—to finance the construction or rehabilitation of low and moderate income housing projects.

Prior to 1968, the only eligible recipient of an Article 2 loan was a corporation called a limited profit housing company (an "LPHC") and not an individual or partnership. In 1968 the State Legislature enacted Section 16 of Article 2. Section 16 was construed as authorizing an LPHC to execute and record a declaration of interest stating that it is holding legal title to a project as general partner of, and on behalf of, a partnership which has the equitable interest therein.

As a result of an amendment enacted at the same time as Section 16, Article 4 authorizes a partnership

to itself qualify as a limited dividend housing company ("LDHC")—as contrasted with Section 16 of Article 2 which, in effect, requires a partnership to act through a corporate LPHC which is a general partner of the Partnership. However, at the time of the granting of the First Mortgage for the Project, the direct partnership approach under Article 4 had rarely been used. Accordingly, in the case of the Project, the Seller decided to utilize the more familiar approach of having a corporate general partner, *i.e.*, Aldus Green Corp. ("AGC") qualify as an LDHC under the PHFL (in this case, Article 4) on its behalf.

In order to comply with the requirements of the PHFL:

(1) AGC was designated as a general partner of the Seller, in addition to Kraus. However, AGC had no interest in the profits, losses or capital of the Seller and no assets or liabilities other than $100 in capital contributed to it by Kraus, and

(2) AGC held legal title to the Project and executed and recorded a declaration of interest stating that it held such legal title as general partner of and on behalf of the Seller.

D. Required Approvals for Sale of the Project

Under Article 4, a LDHC may sell its Project only (1) to a municipality or another Article 4 LDHC: and (2) for a price not in excess of the cost of the Project, less any amounts paid in retirement of the mortgage or of capital contributions. The owner of the Project will be free of this requirement only when after July 31, 1996, it dissolves the LDHC.

The owner of the Project would also be required to obtain HUD consent if it wishes to sell the Project or put an additional mortgage lien on the Project. HUD has issued guidelines as to the circumstances in which HUD may or may not grant its approval to the transfer of a housing project subject to a mortgage loan insured by HUD (and/or receiving Section 8 assistance), or to a transfer of over 50% of the partnership interests in a partnership holding such a project.

IV. Contract to Sell and Closing

A. Date of Contract and Closing

On February 27, 1984, as of February 2, 1984, Seller and the Partnership entered into a Contract to Sell (the "Contract to Sell") providing for Seller's sale of the Project to the Partnership.

The Contract to Sell was amended as of November 30, 1984 (and as thus amended is hereinafter referred to as the "Contract to Sell").

The closing of the sale took place as of the Closing Date. Because the parties were awaiting formal approval from the regulatory agencies, the documents implementing the sale were not executed and exchanged until December 18, 1984.

B. Assets Purchased

Under the Contract to Sell, the Partnership purchased the following assets from the Seller (the "Assets"):

(1) the Project,

(2) related tangible personal property located in the Project, including kitchen equipment.

(3) prepaid expenses, taxes, insurance and amounts held as security deposits,

(4) amounts held as a reserve for replacements,

(5) cash and investment balances, and

(6) all other assets of the Project.

C. Implementation of Sale

To effectuate the sale of the Project hereinafter described in accordance with Article 4, the following steps were taken:

(1) an Amendment to the Declaration of Interest was executed and filed stating that AGC is holding legal title to the Project as general partner of and on behalf of the Partnership, rather than on behalf of Seller,

(2) AGC became the LDHC general partner of the Partnership and withdrew as the LDHC general partner of Seller, and

(3) On the Closing Date the Seller's rights under the Section 8 Contracts were assigned to the Partnership.

C. Obtaining HUD and DHCR Approval

The approval of HUD and DHCR were required and obtained with respect to the transfer of the Project to the Partnership and the placement of additional mortgage liens on the Project.

D. Calculation and Allocation of Purchase Price

Under the formula set forth in the Purchase Contract, the purchase price for the Assets was calcu-

lated and allocated under the Contract to Sell as follows:

Calculation of Total Price

Base price set forth in Contract to Sell	$21,168,356
Plus: Operating liabilities of the Seller as of the Closing Date assumed by the Partnership.	146,212
	$21,314,568

Allocation of Total Price

Prepaid Exp and Other Assets	$110,713
Cash and Investments	1,414,742
Receivables of Section 8 payments from HUD	107,902
Reserve for replacements and other escrow deposits	545,479
	$2,178,836
Personal Property Project:	158,000
Land	395,000
Building	18,582,732
	$21,314,568

E. Payment of Purchase Price

The purchase price was paid as follows:

(1) The $158,000 purchase price for the personal property was paid in cash.

(2) The $2,178,836 purchase price for all of the Assets other than the Project and the personal property was paid as follows:

Cash	$1,754,600

Partnership's acquiring said Assets subject to $424,236 of the balance due from the Seller to Kraus on a note payable on January 9, 1985 having a total principal amount of $1,500,000 (the "Fee Note").* 424,236

$2,178,836

(3) The $18,977,732 purchase price of the Project ($395,000 land and $18,582,732 building) was paid as follows:

(a) by the Partnership's assumption of the operating liabilities of $146,212,

(b) by the Partnership's acquiring the Property subject to the $1,075,764 balance of the Fee Note (that is, the total $1,500,000 Fee Note less the $424,236 taken subject to under 11(2) above), and

(c) by the the Partnership's execution and delivery to the Seller of:

(i) a First Purchase Money Mortgage Note of $11,500,000 which is secured by a second mortgage on the Project and which wraps around the HUD insured First Mortgage (the "First PM Mortgage"), and

(ii) a Second-Purchase Money Mortgage Note of $6,255,756 which is secured by a third Mortgage on the Project (the "Second PM Mort-

* The Seller had issued the Fee Note to Kraus as a bonus for past services in regard to the development and management of the Project.

gage"), and said two PM Mortgages being hereinafter collectively referred to as the "PM Mortgages").

The adjusted basis of the Project (including selling expenses) was $2,135,968. Hence, the total gain realized on the sale of the Project was $16,841,764 (*i.e.* $18,977,732–$2,135,968). The gross profit percentage on the installment sale was:

Total Gain		$16,841,764
Sales Price	$18,977,732	
Less: Assumed Liabilities	1,221,976	17,755,756
Gross Profit %		94.85241%

The gross profit is allocated to the two PM Mortgages as follows:

	Face	%	Deferred Gain
First PM Mortgage	$11,500,000	x 94.85241%	$10,908,028
Second PM Mortgage	6,255,756	x 94.85241%	5,933,736
	$17,755,756		$16,841,764

V. Seller's Transfer of PM Mortgages

On the Closing Date, the Seller transferred the PM Mortgages as follows:

A. The Seller distributed the First PM Mortgage to a liquidating trust known as the Aldus Liquidating Trust ("ALT") for the benefit of Seller's Investor Limited Partners. The trustees of ALT are Stanley Itskowitch, Jacob Kantor and Martin J. Milston.

B. Seller caused the organization A New York corporation named HPM Corporation ("HPM").

Seller contributed $5,100 to HPM in exchange for 51% of its stock and Valerie Kraus (the wife of Kraus) contributed $4,900 to HPM for 49% of its stock.

C. Seller transferred to HPM a 97.9183677% interest in the Second PM Mortgage as an additional capital contribution.

As a condition to Seller making this transfer, Kraus agreed to make capital contributions to the Seller equal to 50% of the expenses of the sale. When added to the 2% share of Kraus and KEI in the Seller, this meant that Kraus would bear 51% of the expenses of the Sale and the Investor Limited Partners would bear 49% of such expenses.

D. Seller distributed its stock interest in HPM to Seller's Investor Limited Partners (other than the Money Store International, Inc., hereinafter referred to as "MSI" and the Estate of Fred S. Fallek*) in proportion to their P&L Percentages as follows:

		P&L Percentage in Partnership	Shares to Be Issued
1)	Kurt P. Duldner 930 Fifth Avenue New York, NY 10021	25	1,356.38
2)	Andrea Klepetar Fallek, Liliane Vladimirschi and Jane Nathanson, as	19	-0-

* The 1030.84 shares that would have been otherwise issued to the Estate (representing a 19% P&L Percentage) were, at the direction of the Estate, distributiod 515.42 shares to each of Liliane Vladimirschi and Jane Nathanson.

	Executors of the Estate of Fred S. Fallek 460 Park Avenue New York, NY 10022 Designees Liliane Vladimirschi Jane Nathanson		
3)	Liliane Vladimirschi c/o Fallek Chemical Company 460 Park Avenue New York, NY	3	678.19*
4)	Jane Nathanson c/o Fallek Chemical Company 460 Park Avenue New York, NY 10022	3	678.19*
5)	Charles W. Russell 19 East 72nd Street New York, NY 10021	10	542.55
6)	Stanley S. Itskowitch 160 East 84th Street New York, NY 10028	1	54.26
7)	Vincent Stabile 57 Cordier Street Irvington, NJ 07111	10	542.77
8)	Antoinette D. Stabile 57 Cordier Street Irvington, NJ 07111	3	162.77
9)	Madeline C. Stabile 57 Cordier Street Irvington, NJ 07111	6	325.53

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* See footnote on page 13.

10)	Paul Heller 300 Winston Drive Cliffside Park, NJ 07010	4	217.02
11)	Money Store International, Inc. 294 Morris Avenue Springfield, NJ 07081	4	-0-
12)	Harold and Edith Lubin 1720 Crestwood Road Elmira, NY	3	162.77
13)	Nathan Picow 1437 Main Street Columbia, SC 29201	2	108.51
14)	Marshall D. and Ronnie Miller Gateway Towers Pittsburgh, PA 15222	2	108.51
15)	Harvey J. Engel 30 East 71st Street New York, NY 10021	1	54.26
16)	Jonathan W. Leigh 17 East 89th Street New York, NY 10028	2	108.51
		98.00%	5,100.00

E. Seller distributed the remaining 2.081633% interest in the Second PM Mortgage to MSI.

The distribution to MSI was made by an assignment which contains and is subject to an irrevocable power of attorney coupled with an interest from MSI to HPM giving HPM the power to exercise as agent of MSI all powers and rights of MSI as co-holder of the Second PM Mortgage except that payments coming due to MSI thereon shall be made directly by the mortgagor to MSI.

VI. Terms of PM Mortgages

As part of the purchase price of the Assets, the Partnership issued to the Seller:

- the First PM Mortgage of $11,500,000 by a Second Mortgage (the First PM Mortgage), and
- a Second PM Note of $6,255,756 which is secured by a Third Mortgage (the Second PM Mortgage).

As set forth above the First PM Mortgage is held by the ALT for the benefit of Seller's Investor Limited Partners. As set forth above the Second PM Mortgage is held by:

- HPM as to a 97.9183677% interest, and
- MSI as to the remaining 2.081633% in the Second PM Mortgage.

The terms of the PM Mortgages include the following:

A. Character of First PM Mortgage as Wrap Mortgage

1. The First PM Mortgage wraps around the First Mortgage. This means that as between the Partnership and the Mortgagee of the First PM Mortgage, the Mortgagee is responsible for payments on the First Mortgage. However, if a default takes place on the First Mortgage, the holder of the First Mortgage could nevertheless foreclose on the Project.

In this regard, the First PM Mortgage further provides that:

(a) The Mortgagee shall not be required to make a payment coming due on the First Mortgage except to the extent that Mortgagee has received payments on the First PM Mortgage to cover said payment, that is, the Mortgagee is not required to utilize its own funds to make payments on the First Mortgage.

(b) If Mortgagee fails to make any payment required to be made by Mortgagee under the First Mortgage, which is required to be performed by Mortgagee, Mortgagee will indemnify the Partnership from any damage sustained by reason of such failure to the extent of the Mortgagee's interest in the First PM Mortgage.

(c) Any voluntary prepayment of principal on the First PM Mortgage must be applied by the Mortgagee to prepayment of the First Mortgage to the extent of the balance due thereon.

(d) The First PM Mortgage (as well as the Second PM Mortgage) contain provisions required by HUD under which

(i) Project operating income must first be applied to payments on the First PM Mortgage which will be applied by the holder thereof to payments on the First Mortgage, and

(ii) further payments on the First and Second PM Mortgages may be made only from "surplus cash" as

defined in the Regulatory Agreement with HUD.

B. Interest

The First PM Mortgage bears interest at 8.75% per annum compounded annually. The Second PM Mortgage bears interest at 11.04% per annum compounded annually.

C. Maturity

The payments required to be made on the PM Mortgages prior to maturity may not be sufficient to cover the interest accruing thereon. The accrued and unpaid interest and the principal of each PM Mortgage are due on the maturity of the PM Mortgage 20 years from Closing Date.

D. Payments Prior to Maturity - First PM Mortgage

Prior to maturity, payments are required to be made on the First PM Mortgage as follows:

(1) The Partnership is required to make a payment of $96,575 per month, which is the amount of the monthly payment which the Mortgagee is required to make on the First Mortgage.

(2) Subject to Paragraph G(4), on July 31. 1996, the Partnership shall make a payment on the First PM Mortgage of an amount equal to:

(a) the greater of: (A) the balance of its cash and investments on December 31, 1995, or (B) the Partnership's Cumulative Cash Flow from the Closing Date through December 31, 1995, less

(b) the sum of the Partnership's reasonable working capital reserve and reserve for replacements, but only to the extent of the sum of (x) accrued and unpaid interest owing on the First PM Mortgage and (y) if DHCR requires the First Mortgage to be prepaid on said date as a condition of the making of the payments due on said date on the PM Mortgages the entire principal balance of the First PM Mortgage.*

(3) To the extent of accrued and unpaid interest on the First PM Mortgage, on June 15 of each year (other than 1996), the Partnership is required to make a payment on the First PM Mortgage equal to its Distributable Cash Flow from the Admission Date (or January 1, 1996 in the case of payments due after 1996) through the end of the preceding calendar year, less the required payments of $82,515 per annum first required to be made from said Distributable Cash Flow on the Second PM Mortgage.

(4) The Partnership is required to deposit with the Mortgagee each month any amounts due that month under the First Mortgage as escrow payments for real estate taxes, water and sewer rents, insur-

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* As explained in "Government Assistance," under Article 4, DHCR may be deemed to have the authority to require the Partnership to prepay the First Mortgage prior to distributing its accumulated cash flow in payment of the amounts due on the PM Mortgages on July 31, 1996.

ance premiums and other expenses– which payments the Mortgagee will, in turn, pay over to the holder of the First Mortgage. (The Partnership acquired the escrow deposits in existence on the Closing Date.)

E. Payments Prior to Maturity—Second PM Mortgage.

Prior to maturity, payments are required to be made on the Second PM Mortgage as follows:

(1) On January 31st of each year (except for 1996), the Partnership is required to make a payment of $82,515 (which under Article 4 is the maximum annual cash flow distributable by the Partnership prior to July 31, 1996),

(2) Not later than June 15 of each year, the Partnership shall pay a payment equal to any further Distributable Cash Flow (above (i) said $82,515 payment and (ii) the required payments from said cash flow of accrued interest on the First PM Mortgage).

(3) Subject to Paragraph G(4), on July 31, 1996, the Partnership shall make a payment on the Second PM Mortgage equal to the excess of (i) the amount determined to be payable by the Partnership under paragraph D(2)(a), over (ii) the portion of said amount required to be paid on the First PM Mortgage under paragraph D(2) (x) and (y).

F. Cash Flow

The terms "Distributable Cash Flow" and "Cash Flow" (with reference to which certain payments on the PM Mortgages are calculated) are defined as follows:

(1) The term "Distributable Cash Flow" means with respect to a specified period the Cumulative Cash Flow in that period (as defined below) to the extent that said Cumulative Cash Flow can be distributed under the Applicable Regulations (including Section 221(d) (4) Section 8, Article 4 and the regulations of and agreements with HUD and DHCR thereunder).

(2) The term Cumulative Cash Flow means the excess of Receipts (as defined below) over Expenditures in a particular period (as defined below).

(3) Receipts shall mean the following revenues to the extent realized by the Partnership under the accrual method of accounting: (i) gross rental income from the Project, and (ii) any investment income. However, there shall not be included as Receipts: (i) any proceeds of a transfer of the Project (since such a transfer is treated as an event of default upon which the PM Mortgages can be accelerated) and (ii) any proceeds of an insurance award resulting from a casualty loss or a condemnation which proceeds shall be applied as provided in the First PM Mortgage and First Mortgage,

(4) Expenditures shall mean amounts paid or incurred for:

(a) all reasonable and necessary operating expenses of the Project including fees of managing agent (not to exceed 9.5% of actual rental collections or such greater percentage as may be authorized by HUD and/or is commonly paid for similar projects in the area) in addition to fees for rerentals and tenant certifications as provided under the terms of the Management Agreement, provided however that any payment for services, supplies or materials made to a Kraus company or any other affiliate of the Partnership shall be deemed an Expenditure only to the extent it is in conformity with the Regulatory Agreement with HUD during such period as said Agreement is in effect and thereafter only to the extent that it does not exceed the amount ordinarily paid for such services, supplies and materials in the area in which the services are rendered or the supplies or materials are furnished,

(b) accounting fees, and other expenses in regard to the preparation of the Partnership's annual financial reports and tax returns, but not any accounting fees in regard to tax audits and subsequent proceedings with respect thereto, and

(c) reasonable legal fees directly related to the operation of the Project (other than those paid from contributions to the Partnership's capital) as well as fees

related to taking action required of the Partnership as described in paragraph G below, provided, however, that for this purpose these fees shall not include any fees related to (A) Federal, state or local income tax matters, (B) matters under Federal, state or local securities law, and/or (C) disputes between the Partnership (and/or Partnership's partners) and the Seller (and/or the Seller's partners or representatives), and

(d) certain capital expenditures,

(e) prior payments on the PM Mortgages.

G. July 31, 1996 Payments

In regard to the payments coming due on July 31, 1996, the PM Mortgages provide that:

(1) The Partnership agrees to take all steps necessary under the Applicable Regulations to permit the payments to be made when due.

(2) The Partnership agrees to use its best efforts to obtain DHCR's consent that the proceeds of the July 31, 1996 payments not be required to be applied to prepayment of the First Mortgage.

(3) In the event DHCR requires that the proceeds of the July 31, 1996 payment be applied to a prepayment of the First Mortgage, holder of the First PM Mortgage shall have the power to require the Partnership to refinance or replace the First Mortgage by a new first mortgage and ap-

ply the net proceeds of the refinancing to the payments on the PM Mortgages that would have been made if DHCR had not required that the First Mortgage be prepaid; provided, however, that: (a) the refinancing is made by an institutional lender, (b) the new mortgage shall be nonrecourse, (c) the principal amount of the new mortgage is not greater than the principal balance on the First Mortgage on the date of the refinancing (plus the expenses of implementing the refinancing), and (iv) the monthly payments on the new mortgage prior to the maturity of the PM Mortgages do not exceed the monthly payments that would have been due on the First Mortgage had it not been prepaid, unless the holder of the First PM Mortgage agrees to make such excess payments.

(4) If (a) DHCR requires that the First Mortgage be prepaid prior to making any payments under the PM Mortgages, (b) the Partnership does not have a sufficient amount available to retire the First Mortgage on July 31, 1996, and (c) the Partnership is not required to implement a refinancing under paragraph G(3) above, then the payments under the PM Mortgages shall be due on the earliest date as of which

(x) DHCR reverses its position referred to in paragraph G(4)(a),

(y) the conclusion stated in paragraph G(4)(b) ceases to be the case, and/or

(z) the Partnership is required to implement a refinancing as referred to in paragraph G(3) above.

H. Application of Payments

(1) Subject to paragraph H(2), all payments on PM Mortgages shall be applied: (a) first, to any expenses of collection of the PM Mortgage after an event of default, (b) second, to accrued interest, and third, to principal amortization.

(2) Any payment on the First PM Mortgage the proceeds of which are applied to a payment of principal on the First Mortgage are to be be treated as a payment of principal on the First PM Mortgage.

I. Prepayment

(1) The Partnership may prepay, without penalty, at any time all or any part of the accrued interest or principal due on the Second PM Mortgage and/or all or any part of the accrued interest due on the First PM Mortgage.

(2) However, the Partnership may not tender a prepayment of all or any part of principal due on the First PM Mortgage unless (a) the prepayment is made after July 31, 1996, (b) the prepayment retires the full balance of principal and accrued interest due on the First PM Mortgage and (c) the Partnership has previously or simultaneously retired the Second PM Mortgage.

Any tender of prepayment in violation of this provision would render the Partnership liable for conse-

quential damages to the holder of the First PM Mortgage.

J. Insurance

The First PM Mortgage requires the Partnership to keep the Project insured against loss or damage by fire and such other hazards as Mortgagee shall from time to time reasonably require in amounts approved by Mortgagee, not exceeding in the aggregate 80% of the full insurable value of the Improvements.

K. Events of Default

The PM Mortgages (and accrued interest thereon) may come due prior to maturity upon the happening of certain events of default which include the following;

(1) the failure of the Partnership to pay any amount due hereunder within 30 days after notice

(2) specified events in regard to bankruptcy and insolvency)

(3) a transfer of the Project,

(4) an event of default under the First Mortgage

(5) an event of default under either of the mortgages securing the PM Notes which include (after notice and specified grace period)

(a) a default in the Partnership's insurance obligations,

(b) any assignment of the rents other than that made pursuant to the First Mortgage, or

(c) failure to comply, or cause compliance, with any order or notice by HUD, DHCR or any other government department.

L. Exculpatory Clause

Each PM Mortgage contains an exculpatory clause under which:

(1) the mortgagee's remedies in the event of default are limited to a foreclosure on the Project, and

(2) the mortgagee cannot obtain a deficiency judgment against the other assets of the Partnership or any partner.

VII. The Offering of Partnership Interests in the Partnership

A. Pursuant to a Confidential Private Offering Memorandum dated September 10, 1984, as supplemented as of November 1984, the Partnership offered to certain investors (the "Investors") 49.5 limited partnership Units (the "Units"), each Unit representing a 2% interest in the profits, losses, cash flow and capital of the Partnership.

Pursuant to an Amendment to the Partnership's Partnership Agreement as of the Closing Date:

(1) the Investors whose Subscription Agreements were accepted were admitted as limited partners,

(2) Kraus paid the balance of the contribution due for a .5 Unit representing a 1% P & L Percentage,

(3) the Partnership interests of HIK was retired in exchange for the Partnership's payment of $99 to HIK, and

(4) ATC (the LDHC general partner of the Seller) become a general partner of the Partnership without any P & L percentage.

Hence, as of the Closing Date, the interests in the Partnership were held as follows:

General Partner	
Kraus	1%
AGC	–
Limited Partners	
Investors	99%
	100%

B. Each Unit was originally offered for sale at a purchase price of $85,228 per Unit, of which $10,392 per Unit would be used to pay fees to certain persons as follows:

1. Helmsley Spear, Inc. ("HSI") would act as finder for the sale of the assets by the Seller to the Partnership and receive for its services a fee of $224,100. ($4,482 per Unit)

2. WMB Securities Corp. ("WMBSC") would act as Placement Agent for the Units and receive a Placement Agent fee of $175,300 ($3,506 per Unit).

3. Wien, Malkin & Bettex ("WMB"), an affiliate of WMBSC, would act as Investment Supervisory Agent for the Partnership for

a period of five years and receive a fee of $107,200 for such services.

4. J.H. Cohn & Company ("JHC") would receive a fee of $10,000 from the Partnership for accounting services and would receive from HSI payment for services rendered by certain partners of JHC in assisting HSI in its role as finder.

Hence, the allocation of the purchase price per Unit was distributed as follows:

	Total	Per Unit
Expenditures other than fees to WMBSC, WMB, HSI, and JHC	$9,744,800	$74,896
Add: Fees to aforesaid persons:	224,100	4,482
HSI finders fee	1,753,000	3,506
WMBSC Placement fee	107,200	2,144
WMB Investment Supervisory Fee	10,000	200
JHC accounting fee		
	$4,261,400	$85,228

C. However, pursuant to a letter agreement between the Partnership, WMBSC, WMB, HSI, and JHC, the foregoing arrangements were changed prior to the Closing Date, as follows:

1. WMBSC withdrew as Placement Agent for the Partnership and WMB resigned as investment supervisory agent for the Partnership.

2. HSI withdrew as finder. However, a senior executive of HSI, Alvin Schwartz ("Schwartz") designated individuals (including himself) to purchase Units (the "Schwartz Subscribers") and HSI agreed to render consulting services to the Partnership on behalf of the Schwartz Subscribers.

3. The Partnership agreed that on the Document Date it would pay WMB a fee of $2,144 for each Unit purchased by the Schwartz Subscribers for services rendered by WMB on behalf of said Subscribers.

4. The accounting fee payable to JHC by the Partnership was increased from $10,000 to $50,000.

5. HSI, which received certain consulting fees, has paid fees to JHC in the amount of $10,000.

D. In view of the foregoing changes, the amount and application of partners' contributions changed as follows:

1. All partners made contributions of a Base Amount applied as follows:

	Total	Per Unit
Expenditures apart from fees to WMBSC, WMB, HSI and JHC	$3,744,800	$74,896
Add: Accounting fee to JHC	50,000	1,000
Base Amount	$3,794,800	$75,896

2. The Partnership placed Units to three groups of Subscribers who, in certain cases, made contributions of above the Base Amount, as follows:

   (a) As set forth above, Schwartz subscribed for Units individually and arranged for the subscription to Units by certain members of his family and associates (the "Schwartz Subscribers").

Schwartz waived any placement fees with respect to the Schwartz Subscribers.

The contributions of the Schwartz Subscribers (and Kraus) funded the fee payable to WMB of $2,144 per Unit purchased by the Schwartz Subscribers (and Kraus).

HSI received a fee of $7,188 per Unit from the contributions of the Schwartz Subscribers (and Kraus) for acting as consultant to the Partnership on their behalf pursuant to a Consulting Agreement entered into with the Partnership on the Closing Date.

As set forth below, these fees resulted in the Schwartz Subscribers paying a price of $85,228 per Unit.

   (b) Astor Securities, Inc. ("Astor") agreed to act as Placement Agent for Units for a placement fee of $1,245 per Unit.

The capital contributions of purchasers designated by Astor (the "Astor Subscribers") also funded fees of $7,188 per Unit to Albert E. Barrette Associates, Ltd. ("Barrette") for acting as consultant to the Partnership on behalf of the Astor Subscribers pursuant to a Consulting Agreement entered into with the Partnership on the Closing Date. This is the same consulting

fee per Unit as was payable to HSI by the Schwartz Subscribers.

(c) LLFZ and JHC arranged for the subscription to Units by their clients and associates (the "Other Subscribers") and waived all placement fees with respect to these Units.

Since LLFZ and JHC were separately compensated by these persons, they agreed to act as consultants to the Partnership on their behalf pursuant to Consulting Agreements entered into with the Partnership on the Closing Date and waived any fees from the Partnership therefor.

(d) In view of the foregoing, the per Unit price payable by the three groups of subscribers and the application thereof was as follows:

	Schwartz Subscribers	Astor Subscribers	Other Subscribers
Base Amount	$75,896	$75,896	$75,896
WMB Fee	2,144	–0–	–0–
Consulting Fee	7,188	7,188	–0–
Placement Fee	–0–	1,245	–0–
Price per Unit Placement from Financing Fee	$85,228	$84,329	$75,896

The Schwartz and Other Subscribers made deposits with their Subscription Agreements of $5,750 per Unit. The Astor Subscribers made deposit of $4,000 per Unit (the "Deposits").

E. After the receipt of the applicable documents from each of the prospective investors (in-

cluding a Subscription Agreement, Deposit, Purchaser Questionnaires, and certain additional documents with respect to certain investors who did not pay for their entire partnership interest in cash), the following persons (the "Investors") were admitted to the Partnership as of the Admission Date:

Limited Partners	Types of Subscriber	No. of Units	P&L Percentage	Price Per Unit	Total Amount Contributed to the Partnership ("Shares in Partnership Capital")
Benzion Benatar	Other	1.0	2%	$75,896	$ 75,896
Charles M. Dubroff	Other	1.0	2	75,896	75,896
Abraham Feinberg	Other	12.0	24	75,896	910,752
Arnold J. Babinec	Other	1.5	3	75,896	113,844
RAB Co.	Other	1.5	3	75,896	113,844
Tom Scheinman	Other	1.5	3	75,896	113,844
Frank Schmeyer	Other	1.0	2	75,896	75,896
Henry Wolf	Other	1.0	2	75,896	75,896
Stephen S. Ziegler	Other	1.0	2	75,896	75,896
Benjamin Alpert	Other	1.0	2	75,896	75,896
Anthony Donn	Other	2.0	4	75,896	151,792
Alfred Plug	Schwartz	1.0	2	85,228	85,228
James V. Igoe	Schwartz	1.0	2	85,228	85,228
Herbert J. Kayden	Schwartz	6.0	12	85,228	511,368
Paul M. Killian	Schwartz	1.0	2	85,228	85,228
Schwartz	Schwartz	9.0	18	85,228	767,052
Thomas H. Schwartz	Schwartz	1.0	2	85,228	85,228
Charles Spielman	Schwartz	1.0	2	85,228	85,228
Brooklyn Associates	Astor	3.0	6	84,329	252,987
Anthony Dengiecki	Astor	1.0	2	84,329	84,329
Samuel Goldberger	Astor	1.0	2	84,329	84,329
		49.5	99%		$3,985,657
General Partner (See note below*)					
Kraus		.5	1%	85,228	42,614
		50.0	100%		$4,028,271

F. On February 27, 1985, an Amended and Restated Certificate of Limited Partnership for the Partnership was filed in the New York County Clerk's Office to reflect the admission of the limited partners and AGC's admission as a general partner.

G. Following the Closing Date the following transfers of partnership interests were made:

(1) As of January 11 & 12, 1985, Schwartz transferred 2 units representing, a 4%

* Paid same price as Schwartz Subscribers.

P&L Percentage and a $151,792 Share of Partnership Capital to Philip 0 Hara, and 1/2 Unit representing a 1% P&L Percentage and a $37,948 share of Partnership capital to George A. Metzger.

(2) As of June 7, 1985, Charles Dubroff transferred 1/4 Unit representing a .5% P&L Percentage and a $18,974 share of Partnership Capital to George P. Lindsay.

Hence, as of June 7, 1985, the partners of the Partnership and their P&L percentages were as follows:

Limited Partners	P&L Percentage
Benzion Benatar	2.0%
Charles M. Dubroff	1.5
Abraham Feinberg	24.0
Arnold J. Rabinor	3.0
RAB Co.	3.0
Tom Scheinman	3.0
Frank Schmeyer	2.0
Henry Wolf	2.0
Stephen S. Ziegler	2.0
Benjamin Alpert	2.0
Anthony Donn	4.0
Alfred Flug	2.0
James V. Igoe	2.0
Herbert J. Kayden	12.0
Paul W. Killian	2.0
Alvin Schwartz	13.0
Thomas H. Schwartz	2.0
Charles H. Spielman	2.0
Brooklyn Associates	6.0
Anthony Densieski	2.0
Samuel Goldberger	2.0
George A. Metzger	1.0

Philip O'Hara	4.0
George P. Lindsay	.5
General Partner	
Kraus	1.0
	100.0%

VIII. Certain Fees Payable

The calculation of fees payable to WMB, HSI. Astor and Barrette in accordance with the principles set forthe in Section VII above, the payments on account of said fees and the amounts due thereon are as follows:

	WMB	HSI	Astor	Barrette
Units	20.5	20.5	5	5
X Fee Per Unit	$2,144	$7,188	$1,245	$7,188
Total Fee	$43,952	$147,354	$6,225	$35,940
Less: Offset of	(1,072)	(3,594)		
Schwartz receivable	-0-	-0-	(5,844	(34,121)
Less: Payments –	(41,808)	(140,166)	(381)	(1,819)
Seller				
Less: Payments –				
Partnership				
Amounts Due	$1,072	$3,594	-0-	-0-

IX The Investor's Notes

A. Originally, the Partnership did not offer financing for the purchase price of a Unit. However, pursuant to a Supplement to Private Placement Memorandum, the Partnership offered to arrange loans to certain subscribers through New England Financial Management, Inc. ("NFM") and the Partnership agreed to pay on behalf of a Subscriber desiring such financing a financing fee of not more than 5% of the loan amount.

However, as of the Closing Date, NFM was unable to arrange financing for the subscribers and instead, the Seller agreed to advance funds on behalf of the investor's financing the purchase of their Units.*

The amounts financed, the financing fees charged by the Seller, and the prices including financing fees were calculated as follows:

Calculation of Amount of Loan	Subscribers Designated by:		
	Schwartz Subscribers	Other Subscribers	Astor Subscribers
Price Apart from Financing Fee	$85,228	$75,896	$84,329
Less: Deposit	5,750	5,750	4,000
Amount to be financed (apart from financing fee)	$79,478	$70,146	$80,329
Divided by .94 (to reflect 6% financing fee)	/.94	/.94	/.94
Total Loan	$84,551	$74,623	$85,456
Calculation of Price Including Financing Fee			
Price apart from Financing Fee	$85,228	$75,896	$84,329
Add: Financing Fee	5,073	4,477	5,127
Total Price per Unit including Financing Fee	$90,301	$80,373	$89,456

B. The following Investors financed part of their contributions to the Partnership by loans from the Seller evidenced by notes issued to the Seller (the "Investor's Notes"):

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* The Seller obtained these funds by a loan from Citibank. N.A. which Seller repaid from the proceeds of the sale.

Name of Limited Partner	Amount of Note
Kraus	$ 39,739
Schwartz	42,614*
Abraham Feinberg ("Feinberg")	895,476
Benzion Benatar ("Benatar")	74,623
Frank Schmeyer ("Schmeyer")	74,623
Brooklyn Associates ("Brooklyn")	256,368
Anthony Densieski ("Densieski")	85,456
Samuel Goldberger ("Goldberger")	85,456
	$1,554,355

C. Each Investor's Note, excepting the Feinberg Note, is payable as follows:

1. interest accuries at 1-1/2% per annum above the published prime rate of Manufacturer's Hanover Trust Company, New York (the "MHT" Rate"),

2. accrued interest only payable on December 31, 1984,

3. accrued interest payable quarterly commencing March 31, 1985, and

4. principal payable in 20 quarterly installments commencing on March 31, 1985 and ending on December 31, 1989, in an amount equal to 1/20th of the original principal amount of the Investor Note.

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* Subsequent to the Admission Date, Schwartz sold the .5 Unit purchased with his note of $42,614. Schwartz's then paid said $37,948 to the Partnership on account of the balance due on his note. The Partnership offset its remaining receivable of $4,666 on the Schwartz Note against its obligation to pay $1,072 of the remaining balance due to WMB and $3,594 of the remaining balance due to HSI.

D. Feinberg's Note is payable as follows:

1. interest accures at a rate equal to 1-1/2% per annum above the MHT Rate
2. accrued interest only payable on December 31, 1985.
3. accrued interest at payable in 24 quarterly installments, commencing March 31, 1985, and
4. principal payable in 24 quarterly installments commencing on March 31 1985 and ending December 31, 1990, representing percentages of the face amount of the Feinberg Note specified in an exhibit thereto as follows:

Date of Payment	Amount of Principal Installment as a % of the Initial Principal Amount of the Note
3/31/85	2.81489%
6/30/85	2.90637
9/30/85	3.00083
12/31/85	3.09836
3/31/86	3.19906
6/30/86	3.30302
9/30/86	3.41037
12/31/86	3.52121
3/31/87	3.63565
6/31/87	3.75381
9/30/87	3.87581
12/31/87	4.00177
3/31/88	4.13183
6/30/88	4.26611
9/30/88	4.40476
12/31/88	4.54792
3/31/89	4.69572
6/30/89	4.84833
9/30/89	5.00591
12/31/89	5.16860
3/31/90	5.33658
6/30/90	5.51002
9/30/90	5.68909
12/31/90	5.87399
	100.00001%

Each Investor's Note is secured under a Security Agreement between the Seller and the particular investor in which the Investor granted a security interest to the Seller in the Investor's Partnership Interest.

On January 9, 1985, Kraus purchased an undivided 50% interest in the Investor Notes from Seller for the sum of $708,272, computed as follows:

Face Amount of Notes	$1,554,355
Less: Discount included in notes	(88,313)
Less: Obligations to pay fees on behalf of Partnership included in notes*	(49,497)
Net value of Notes	$1,416,545
x 50%	x 50%
Purchase Price	$708,272

On the same date, the Partnership distributed the remaining 50% undivided interest in the Investor Notes to ASC on behalf of the Investor Limited Partners. The Investor Limited Partners' capital accounts were charged with the same amount as was paid by Kraus for the other 50% interest in the Investor Notes.

G. As of April 1, 1985 (after the collection of the March 31, 1985 interest payment due on the Investor Notes), ASC and Kraus agreed to divide the Investor Notes among themselves, so that the only Investor from

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* These obligations were:

WMB	$ 2,144
HSI	7,188
Astor	5,930
Barrette	34,235
	$49,497

which each would hold notes would be Feinberg. This division was accomplished as follows:

Investor	Amount of Note	Kraus	ASC
Kraus	$39,739	$39,739	85,456
Brooklyn	256,368	256,368	74,623
Goldberger	85,456	85,456	74,623
Densieski	85,456	394,177	501,299
Benatar	74,623		
Schmeyer	74,623		
Feinberg	895,476		
	$1,511,741*	$775,740	$736,001

Amount of Note	Transferee
$347,338	Kraus
46,839	Kraus
501,299	ASC
$895,476	

To implement this transaction, Feinberg's Investor's Note of $895,476 was cancelled and Feinberg executed three new notes on the same terms and conditions as the original note as follows:

Feinberg executed new Security Agreements to secure the repayment of the new notes.

Kraus should have received notes for 51% of the total or $770,988. Due to a clerical error he was assigned notes of $775,740. Accordingly, Kraus submitted a letter to ASC stating that he would pay to ASC

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* This represents the total notes received of $1,554,355 less the Schwartz note of $42,614 which was satisfied.

.6126% of his collections on the notes. (that is, $4,752/$775,740)

X. Distributions by Seller

The Partnership made the following distributions from the proceeds of the sale:

A. As set forth above, after the sale of a 50% interest in the Investor Notes to Kraus, the Seller distributed the remaining 50% interest in the Investor Notes to its partners in proportion to its P&L Percentages.

B. On January 9, 1985, the Seller made a further distribution of $633,308 to its partners in proportion to their P&L Percentages.

C. In June, 1985, the Seller made a further distribution to the partners and a payment to Kraus of $85,613 as set forth in Section XI below.

XI. Closing Expenditures

A. Seller

1. Overall Receipts and Disbursements

The Seller's receipts and disbursements from the Closing Date through May 24, 1985 (the balance of which receipts and disbursements was distributed to Seller': partners) were as follows:

CASH RECEIPTS APART FROM NOTE COLLECTIONS

1984 distribution released from DHCR regulated funds	$82,515
Payment from ASC (see below)	41,791
Cash Proceeds of sale of Assets	1,912,600

Loan from Citibank		1,415,000
Proceeds of sale of Notes to Kraus		708,272
Kraus capital contributions ($114,982+$5,000)*		119,092
Adjustment		3
TOTAL CASH RECEIPTS		$4,279,273
CASH DISBURSEMENTS		
Repayment of loan from Citibank		$1,415,000
Reimbursement Kraus Management Inc. expenses		3,912
Loans to Investors in Partnership ($1,415,000+$1,545)		1,416,545
NYS transfer tax		75,928
NYC transfer tax		379,635
NYS Gains Tax		55,997
Distribution Of Capital (1/9/85)		
Kraus (1%)	$ 6,383	
KEI (%)	6,383	
Investor limited partners (98%)	620,542	633,308

* The $5,000 represents the Kraus/KEI share of the $250,086 contributed to ASC (see below)

The $114,982 represents a payment on account of the Kraus obligation to pay 50% of the expenses of the sale.

Repayment of fees and expenses to Kraus and KEI		56,362*
Insurance - General Partner		6,731
Citibank - Finance fee		12,500
NYS Sales tax on sale of personal property		13,035
Investment in HPM Corp.		5,100
Loan to Partnership		15,164
Payment of Fees on Behalf of Partnership		
Barette	$34,121	
Astor	5,844	
		39,965
Demov Morris - legal fee (counsel Citibank)	2,000	
Kraus & Kraus - legal fee	2,325	
LLFZ legal fee and disbursements	122,800	
JHC accounting fee	25,000	
Bank charges	43	
TOTAL CASH DISBURSEMENTS		$4,281,350
CASH BALANCE (Deficit) May 24, 2985 – Apart from note collections		($2,077)
Less: REQUIRED RESERVES		

* This payment came from the $82,515 funds released by DHCR leaving the Seller with a net receipt of those funds of $26,153.

To pay further premiums on General Partner	$15,269	
Insurance	50,000	
		65,269
NET PROCEEDS (Deficit) APART FROM NOTE COLLECTIONS		($67,346)
ADD: NOTE COLLECTIONS (SEE ¶ 3 BELOW)		152,958
NET DISTRIBUTION		$85,612

2. Receipt from ASC

The $41,791 amount received from ASC represents the following:

(a) In 1983, the Partners were called upon to make contributions of $250,086 of which $240,086 had been paid.

The unpaid shares were:

Kraus	$2,500
KEI	2,500
Picow	5,000
	$10,000

The Kraus and KEI shares are included in their capital contributions shown above. The Picow amount was subtracted from his share of the January 9, 198S distribution:

(b) The amounts disbursed by ASC and the balance paid to the Seller were as follows:

Total in Fund	$240,086
Less:	
Expenditures	

LLFZ fees		$127,368	
Selling Expenses			
LLFZ Disbursements	$9,556		
ASC Fees	6,000		
JHC Fees	20,681	36,237	
Misc. Expenses*			
Arnold Rabinor Fee	$28,000		
Brody & Brody Fee	6,690	34,690	
Total Disbursements			198,295
Balance			$41,791

3. Allocation of May 1985 Distribution

(a) The allocation of the May, 1985 distribution among Kraus and the Investors Limited Parnters was as follows:

	Total	General Partner	Investor Limited Partners
Allocation of notes receivable collections (see next schedule)	$152,958	$78,009	$74,949
Allocation of deficit (51% Kraus, 49% Investor Limited Partners)	(67,345)	(34,346)	(32,999)

* For planning acquisition of property not made.

Distribution payable	$85,613	$43,663	$41,950
Distribution made	85,613	44,065	41,548
Adjustment to be made	-0-	$(402)	$402

The allocation of the distribution among the Investor Limited Partners is shown in Exhibit B.

(b) The allocation of the note collections was as follows:

	Total Total	Kraus Kraus	Investor Limited Partners
Alvin Schwartz Note - principal	$37,948.00	$19,353.48	$18,594.52
12/31/84 Interest	16,608.45	8,470.31	8,138.14
3/31/85 Interest and principal	101,523.32	51,776.89	49,746.43
Total	$156,079.77	$79,600.68	$76,479.09
Less: 2% Collection Fee	3,121.60	1,592.02	1,529.58
Net Collection	$152,958.17	$78,008.66	$74,949.51

B. Partnership

Apart from operations of the Project, the Partnership's receipts and disbursements from the Closing Date through March 31, 1985 were as follows:

RECEIPTS

Total capital contributions (Section VII(E))	$4,028,271
Less: Withheld to pay fees on behalf of Partnership (See Section IX(F))	49,497

Net Capital Contributions ($3,977,229 + $1,545)		$3,978,774
Loan from Seller		15,164
Interest income		4,512
		$3,998,450
DISBURSEMENTS		
Cash Portion of sales price	$1,912,600	
Payment of Fee Note to Kraus (1/9/85)	1,500,000	
Interest expense on Fee Note *(12/1/85-1/9/85)	15,164*	
Fee to		
WMB	41,808	
HIS	140,166	
Barnette	1,819	
Astor	381	
LLFZ Fee	100,000	
JHC accounting fee	50,000	
Mortagae recording tax	145,325	
LLFZ disbursements	25,292	
Title policy premium - LTIC**	48,352	
Appraisal fee – Appraisers and Planners, Inc.	15,000	

* Kraus was overpaid an additional $2,500 but will be refunded.

** Checks of $45,970 and $2,412.

Service Charge	77	
Adjustment	3	3,998,487
		$ (37)

XI. Summary of The Limited Partnership Agreement

Certain selected provisions of the Limited Partnership Agreement are briefly summarized below:

A. Distributions and Allocation of Profits and Losses.

All distributions by the Partnership will be made in proportion to the Profit and Loss Percentages of the partners (the "P&L Percentages").

For Federal, state and local income tax purposes, all items of Partnership net income, net loss and net credit will be allocated among the partners in proportion to their P&L Percentages.

B. Term of Partnership.

The Partnership will dissolve on the earliest of:

(1) February 28, 2034,

(2) the sale or other disposition of all of the Partnership's interest in all of the Project and the collection and/or disposition of all purchase money obligations arising from the Partnership's sale or other disposition of the Project.

(3) the occurrence of any of the following events with respect to Kraus if Kraus is acting as General Partner:

(a) death, insanity or bankruptcy, or

(b) Kraus resigning as General Partner upon thirty (30) days notice to the partners,

(c) a transfer of Kraus' partnership interest which leaves Kraus with an aggregate partnership interest having less than either: (i) a 1% P&L Percentage, or (ii) 1% of the aggregate Shares in Partnership Capital, or

(4) a dissolution as provided by law, or

(5) the event that, after a notice of foreclosure on the Project has been served on the Partnership and before said notice is withdrawn, Limited Partners holding over 66-2/3% of the P&L Percentages give notice that they wish to terminate Kraus' status as General Partner, provided, however, that such a notice must be accompanied by a designation of a substitute General Partner.

The General Partner has agreed (in the Partnership Agreement) not to resign or voluntarily transfer his Partnership Interest before July 31, 1997 unless:*

(1) the Management Agreement with KMI has been earlier terminated either by the Limited Partners acting pursuant to the terms of the Management Agreement or

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* Seller initially filed a return showing approximately $7,000 due. The New York State Department of Taxation and Finance contested this figure and asserted that a tax of approximately $465,000 was due.

An audit was held and the Department agreed to reduce the tax assessment to $55,997, which the Seller paid.

by the act of a government agency acting pursuant to its powers under applicable law,

(2) a notice of foreclosure on the Project has been served.

If any event should occur which causes the dissolution of the Partnership (other than certain types of dissolutions by law), the Partnership shall automatically be reconstituted as a new partnership if, within 60 days after the occurrence of such event, Limited Partners holding over 50% of the P&L Percentages designate one or more qualified persons to become a general partner or general partners of the new partnership.

The Partnership shall not dissolve upon the death, insanity, incapacity or bankruptcy of a Limited Partner, or the transfer of the partnership interest of a Limited Partner.

C. Restrictions on Transfers of Partnership Interests.

The following provisions in the Limited Partnership Agreement will restrict the transfer of the partnership interest of a Limited Partner:

(1) In any period of 12 consecutive months, a transfer of a partnership interest may not be made by a partner after transfers have already taken place in said period of partnership interests aggregating over 47%. This limitation does not apply to a transfer by bequest, devise, inheritance, or a transfer to the Partnership.

(2) A transferee of a Limited Partner's partnership interest may become a

Limited Partner only with the consent of the General Partner, which consent may be withheld in the General Partner's complete discretion and shall be withheld to prevent a violation of the 47% limitation.

(3) The transfer of a Limited Partner's Partnership Interest shall conform to applicable law and shall be subject to the approval of HUD and/or DHCR to the extent required under applicable law.

(4) No transfer of a Partnership Interest may be made which would have the effect of increasing the number of partners to a level which would at any time, result in the automatic disqualification of the Partnership as a "partnership" for Federal income tax purposes.

D. Accounting, Tax Reports and Tax Matters Partner.

The accounting period of the Partnership will be the calendar year. As soon as possible after the end of each calendar year, the Partnership will furnish each partner with the following:

(1) an income statement for the calendar year,

(2) a balance sheet of the Partnership at the end of the calendar year,

(3) a Statement of Changes in Financial Position for the calendar year, and

(4) a copy of the Form K-1 to the Federal information return of the Partnership for the calendar year showing the allocation of income and deductions to the partner, pro-

vided, however, that the K-1 shall be furnished within 90 days after the end of the calendar year.

The financial statements shall be accompanied by a statement of independent certified public accountants, made on the basis of an audit performed by said accountants that said financial statements were prepared in accordance with generally accepted accounting principles consistently applied utilizing the accrual method of accounting.

The Tax Matters Partner shall be the general partner.

F. Amendments.

An amendment to the Partnership Agreement requires the written consent of all partners if it varies:

(1) the general character of the Partnership's business,

(2) the provisions upon which a transferee of a Partnership Interest may be admitted as a Limited Partner, and if the transferee is not admitted, the respective rights of the transferor Limited Partner and said transferee or

(3) the events which shall cause a dissolution of the Partnership, and the terms upon which the dissolved Partnership shall be reconstituted as a new partnership.

Any other amendment requires only the written consent of:

(a) the General Partner, and

(b) Limited Partners who hold, in the aggregate, P&L Percentages in excess of 50%.

The Partnership Agreement cannot be amended without the approval of DHCR as long as DHCR, under applicable law, has authority to regulate the Project.

G. Powers of General Partner.

1. In addition to any other powers conferred upon the General Partner by law, and except as otherwise provided in the Limited Partnership Agreement, the General Partner shall have the powers on behalf of the Partnership to:

   (a) acquire the Project and lease the Project to tenants,

   (b) borrow money, with or without security, (subject to the power of the Limited Partners discussed below to approve certain refinancing)

   (c) acquire products, insurance and other services for use in the Partnership's business and engage such persons as the General Partner deems advisable for the Partnership's business including, as discussed below, KMI and other affiliates of the General Partner

   (d) determine when distributions shall be made (prior to dissolution) and whether distributions are to be made wholly or partly in property other than cash,

   (e) execute and deliver any instrument required or approved by DHCR or any other government agency,

(f) subject to the provisions described above (see "The Limited Partnership Agreement Accounting, Tax Reports and Tax Matters Partners"), determine the Partnership's accounting methods, principles, practices, and elections for financial accounting and tax purposes and deliver all Partnership income tax and other tax returns, and

(g) take any other action necessary or incidental to the business of the Partnership.

2. The General Partner agrees that the General Partner will:

(a) exercise the powers of the General Partner in a fiduciary capacity on behalf of the Partnership and its Limited Partners, with a reasonable degree of skill and care and with a view toward furthering the Partnership's profitable development, operation and/or disposition of the Property.

(b) devote such of the General Partner's time to the business of the Partnership as he deems necessary,

(c) not take any action which would, in the opinion of counsel, result in a termination of the Partnership for Federal income tax purposes or in its failure to be so classified, and

(d) not resign or voluntarily transfer his partnership interest before July 31, 1997 except in the instances discussed

above under "The Limited Partnership Agreement - Term of Partnership"

3. Without the approval of Limited Partners holding in the aggregate a greater than 50% P&L Percentage, the General Partner may not:

   (a) sell, exchange or otherwise transfer Project or grant options with respect thereto,

   (b) lease the Project except to tenants, or

   (c) mortgage, pledge or otherwise encumber the Project, or refinance the First PM Mortgage, the Second PM Mortgage, or (except as provided in the First PM Mortgage) the First Mortgage.

4. Fiduciary Duty of General Partner and Indemnity.

As General Partner, the General Partner is accountable to the Partnership as a fiduciary and consequently must exercise good faith and integrity in handling Partnership affairs. Thus, in the Limited Partnership Agreement the General Partner agrees that he will "exercise the powers of the General Partner in a fiduciary capacity on behalf of the Partnership and its Limited Partners."

The Partnership may obtain services from or sell, purchase or lease property to or from or effect any other transaction with the General Partner or an affiliate of the General Partner, provided however that the charges for such services, supplies or materials shall not exceed the amount ordinarily paid for such services, supplies or materials in the area where the

services are rendered or the supplies or materials are furnished.

The General Partner may cause the Partnership to maintain its accounts in the same bank with which the General Partner, or an affiliate, is interested, has a banking relationship, or is otherwise connected.

The Partnership, to the extent of its net assets, and to the extent permitted by law, shall indemnify the General Partner against and hold him harmless from any damage, loss, liability or expenses incurred by him in connection with or resulting from any act or omission to act on behalf of the Partnership, on a material matter other than his own act or omission to act in bad faith such as fraud with an actual intent to deceive.

The General Partner shall not have any liability to the Partnership or any Limited Partner other than for his own act or omission to act on a material matter in bad faith such as fraud with an actual intent to deceive. The sole remedy for such an act or omission shall be the recovery of money damages from the General Partner.

As a result of these indemnification arrangements, a Purchaser of Partnership Units may be restricted to a more limited right of action than he would otherwise have received on a purchase of such Units absent this limitation in the Partnership Agreement. In the opinion of the Securities and Exchange Commission, indemnification for liabilities arising under the Securities Act is against public policy and therefore unenforceable.

XII. Summary of the Management Agreement

On the Admission Date the Partnership will enter into the Management Agreement with KMI, retain-

ing KMI as its sole and exclusive agent to rent and manage the Project.

Certain other provisions of the Management Agreement are as follows:

A. The Management Agreement provides for monthly compensation to KMI in an amount equal to (1) 7 1/2% of gross rental income received during the preceding month (2) plus an additional 2% of gross rental income received per annum to the extent that the Partnership's cash flow exceeds the maximum distributable on DHCR regulations. In recent years, the cash flow has been sufficient to pay the additional 2% fee. In addition, for rerentals of apartments, KMI will receive from the Partnership $50 for each apartment rerented. For each recertification of tenant income required under applicable law, KMI will receive the sum of $50 per apartment to the extent said fees are not disallowed by HUD and/or DHRC as expenses of the Project.

B. The Management Agreement shall commence on the Admission Date and shall terminate on the earliest of:

(1) July 31, 1997,

(2) the sale of the Project by the Partnership,

(3) the liquidation of the Partnership in accordance with the Limited Partnership Agreement,

(4) a government agency, acting under applicable law, terminating or requiring the Partnership to terminate KMI's status as Managing Agent (and upon any such

termination, Kraus may resign as General Partner),

(5) after a notice of foreclosure has been served on any mortgage and before said notice has been withdrawn, Limited Partners holding over 66 2/3% of the P&L Percentages give notice to KMI that they wish to terminate the Management Agreement, or

(6) Kraus ceasing to be General Partner.

Upon any termination of KMI as Managing Agent, Kraus may resign as general partner.

C. KMI's powers and duties with respect to the Project are to perform all services necessary or appropriate for the management of the Project, including:

(1) KMI shall use all reasonable efforts to keep the apartments in the Project fully rented to desirable tenants.

(2) KMI shall use its best efforts to collect all rentals due from tenants.

(3) KMI shall, from time to time, file and process applications for rent increases with the applicable governmental agencies but KMI does not represent or guarantee the granting of such rent increases.

(4) KMI shall manage the Project so that the buildings and the surrounding areas are maintained in a first-rate, excellent physical condition.

(5) KMI shall employ, discharge, supervise and pay, on behalf of the Partnership, su-

perintendents, porters and such other employees as may be necessary for the efficient management of the Project. While these persons shall be KMI employees, the Partnership will reimburse KMI for payments - of all wages, and other payroll related costs in regard to employment of such employees.

(6) KMI shall, on behalf of and at the expense of the Partnership, arrange for all necessary or advisable materials and services for the Project (including insurance, utilities, refuse disposal, security and vermin extermination).

(7) KMI shall, on behalf of and at the expense of the Partnership, make all repairs and alterations, in or about the Project.

EXHIBIT H

THE TAX INCENTIVES FOR LOW AND MODERATE INCOME HOUSING

Kaiser Commission Report

The concept for investment in low and moderate income housing incentives proposed in a report issued in 1968 by the President's Commission on Urban Housing (the "Kaiser Commission").

In the course of its exhaustive investigation of U.S. housing, the Kaiser Commission found that almost eight million American families could not afford decent housing (p. 7 and 41). It determined that national housing goals could be attained only through greater participation by private enterprise (p. 23 and 75) and that federal Tax Incentives were mandatory if private industry was to be attracted to the development of low income housing (pp. 17-18 and p. 84).

To induce greater private sector participation in the production of low and moderate income housing, the Kaiser Commission (among other things) conceived the idea of Congress forming a quasi public entity to organize, on a national basis, partnerships to invest in low and moderate income housing (p. 17 and pp. 85-87). The principal inducement for investment in the partnerships would be tax losses on investments in housing projects which could be used to offset the investors' other income for tax purposes. The tax savings on the other income would represent the investor's return from the project (pp. 18-19 and pp. 82-83).

Excerpts from the Kaiser Commission report (as well as excerpts from the legislative history of certain of the incentives described below) are included in Exhibits C and D.

Housing and Urban Development Act of 1968

The Housing and Urban Development Act of 1968 (the "1968 Act") organized part private/part public entities named the National Corporation for Housing Partnerships ("NCHP") and National Housing Partnerships (the "NHP"). In reliance on the tax in incentives, the NHP made investments in low and moderate income housing projects, having an aggregate development cost of over $1.3 billion.

The declaration of purpose in the 1968 Act (§901) stated:

> The Congress finds that the volume of housing being produced for families and individuals of low or moderate income must be increased to meet the national goal of a decent home and a suitable living environment for every American family, and declares that it is the policy of the United States to encourage the widest possible participation by private enterprise in the provision of housing for low or moderate income families. The Congress has therefore determined that one or more private organizations should be created to encourage maximum participation by private investors in programs and projects to provide low and moderate income housing. Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 1968, U.S. Code Cong. Ad. News 547, 637.

The Kaiser Commission Report and the annual reports of NHP provide overwhelming evidence of:

—Congressional and executive branch endorsement of the Tax Incentives and awareness of the Tax Incentives and how they work (that is,

by the offset of project losses against investor's other income),

—the persistent long standing appeal for private investment in low and moderate income housing made by this quasi public agency (CNHP) in accordance with its Congressional mandate based on the Tax Incentives, and

—the enormous investments in low and moderate income housing made through NHP based on the Tax Incentives, in addition to the even greater investments made by private developer/investors acting on their own in a manner and in a legal format (limited partnerships) similar to that used by NHP.

The 1968 Act also contained provisions (§§ 106-07) to encourage cooperative and non-profit sponsors to purchase projects which had initially been developed and held by partnerships of persons who had invested based on that Tax Incentives.

Thus, in one report on the 1968 Act, a Congressional committee stated:

> The partnership arrangement makes it possible to assure an adequate return to investors. Under existing Internal Revenue Service regulations and rulings, partnership losses for tax purposes flow to the individual partners. In the case of new housing units financed on a 10-percent equity
>
> —90 percent debt basis, the annual accelerated depreciation of the building cost results in substantial book losses during the initial 10 years after the project is built. Assuming the member of the partnership is in [a] relatively high income

> tax bracket his share of the depreciation losses, plus cash income from project operations would provide an after-tax return on his investment which would compare favorably with the return which most industrial firms realize on their equity capital. Senate Finance Committee, Report on the Housing and Urban Development Act of 1968 (S. Rep. No. 1123, 90th Cong., 2d Sess. 85 (1968)).

Amortization of Rehabilitation Expenditures

The Tax Reform Act of 1969 enacted Section 167(k) of the Code, which authorized rapid (60 month) amortization of expenditures for the rehabilitation of low and moderate income housing. Tax Reform Act of 1969, §521, Pub. L. No. 91-172, 1969 U.S. Code Cong. & Ad. News 509, 706-709. This provision was extended several times through 1988. [1]

Seller utilized this 60 month depreciation in regard to its development of the project.

The Committee Report on one of the laws extending Section 167(k) stated:

> In the Housing and Community Development Act of 1974, the Congress expressed its desire to stimulate construction in low and middle-income housing to eliminate the shortage in this area. However, the special tax incentive for rehabilita-

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[1] Internal Revenue Service Code Amendments, etc., Pub. L. No. 93-625, §3(c), 1974 U.S. Code Cong. & Ad. News 2447, 2448; Tax Reform Act of 1976, Pub. L. No. 94-455, §203, 1976 U.S. Code Cong. & Ad. News (90 Stat.) 1520, 1530; Temporary Tax Provisions – Extensions, Pub. L. No. 96-541, §3, 1980 U.S. Code Cong. & Ad. News (94 Stat.) 3204, 3205; Deficit Reduction Act of 1984, Pub. L. No. 98-369, §1064, 1984 U.S. Code Cong. & Ad. News (98 Stat.) 494, 1047 (all amending Section 167(k)).

> tion expenditures for low-income rental housing under the present law expires on December 31, 1975. Without this incentive the remodeling of many high-risk low-income projects may be curtailed. In order to avoid discouraging this rehabilitation, the committee believes that the special depreciation provision for low-income housing should be extended. (Emphasis added.) H.R. Rep. No. 658, 94th Cong., 2d Sess. 182, reprinted in 1976 U.S. Code Cong. & Ad. News 2897, 3076.

The aggregate amount of rehabilitation expenses amortizable under this Section was not to exceed a specified amount increased over the years from a starting figure of $15,000 per unit to up to $40,000 per unit in certain circumstances.

As stated in the Committee Report on one of the extensions (P.L. 93-625):

> In general, rapid amortization was made available as an alternative to the investment tax credit that was repealed in the 1969 Act. Each of the types of investment eligible for rapid amortization was considered important to the success of an existing social policy. Those programs relied entirely or partially upon private investment in order to accomplish their objectives, and Congress believed that an additional investment incentive restricted to these activities should be made available in lieu of the investment credit. When the investment credit was reenacted in 1971, Congress specifically provided that the investment credit and rapid amortization both would not be available for the same investment. A taxpayer may elect either the investment credit or rapid amortization.

All four of these special amortization provisions were enacted for a 5-year period which expires at the end of 1974.

After consultation with the appropriate Federal officials and public hearings during which interested private parties expressed their views, the committee concluded that there was still sufficient need for these provisions to warrant extending the expiration dates. . . .

These four amortization provisions are summarized as follows:

Rehabilitation of low and moderate income rental housing (sec. 167(k). Taxpayers may elect to compute depreciation on rehabilitation expenditures incurred after July 24, 1969, on low and moderate income rental housing under the straight line method over a period of 60 months, if the additions or improvements have a useful life of 5 years or more. This rapid amortization is available only for low-income rental housing where the dwelling units are held for occupancy by families or individuals of low or moderate income, consistent with the policies of the Housing and Urban Development Act of 1968. (Emphasis added.) S. Rep. No. 1357, 94th Cong., 2d Sess., reprinted in 1976 U.S. Code Cong. & Ad. News 7478, 748-83.

Similarly, it was stated in the Committee Report on P.L. 94-455 (one of the extending laws):

In the Housing and Community Development Act of 1974, the Congress expressed its desire to stimulate construction in low- and middle-income housing t eliminate the shortage in this area. However, the special tax incentive for rehabilita-

tion expenditures for low-income rental housing under present law expires on December 31, 1975. Without this incentive the remodeling of many high-risk low-income projects may be curtailed. In order to avoid discouraging this rehabilitation, [the] committee believes that the special depreciation provision for low-income. S. Rep. No. 658, 94th Cong., 2d Sess. 182, reprinted in 1976 U.S. Code Cong. & Ad. News 2897, 3076.

Exception to Depreciation Recapture

In the Revenue Act of 1964, Congress adopted the concept of recapture on a sale of a rental property (recapture means the treatment as ordinary income of gain realized) on the sale of real property of the excess of accelerated depreciation over straight-line depreciation ("excess depreciation"). The portion of the excess deprecation subject to receptive was to decline as the holding period for the property increased.

The Tax Reform Act of 1976 tightened the rules for recapturing excess depreciation on residential real property. In the case of residential real estate, all post-1975 excess depreciation would be subject to 100% recapture. However, in the case of a government-subsidized housing project, the 1976 Act retained the prior provision for phaseout of recapture at 1% per month starting after 100 months.

Under Section 1250(a)(1)(B), a project qualifies for this and other tax benefits only if the project is "limited" as to "rentals," and "rate of return."

Deferral of Taxable Gain

Section 1039 enacted by the Tax Reform Act of 1969 (Pub. L. No. 91-172, §910, 1969 U.S. Code Cong. & Ad. News at 793-98) provides rules under which a

taxpayer may elect not to recognize (*i.e.*, defer) gain in certain cases, when a "qualified housing project" is sold or disposed of in an approved disposition and the taxpayer acquires, constructs or reconstructs within a specified reinvestment period another such qualified housing project or projects.

To be eligible for deferral under Section 1039, the project sold must provide rental housing for low-income families and must be:

(a) financed by a mortgage insured under Section 221(d)(3) or 236 of the National Housing Act; and

(b) subject to limitations on the return that the owner may receive on his investment and with respect to the rentals that may be charged. (§910 at 794.)

The sale of the project must be made to the tenants or occupants of the units of the project (or to a nonprofit management organization formed and operated for the benefit of these persons), and approved by HUD.

The gain on the approved disposition will be deferred except to the extent that the net amount realized on the disposition exceeds the taxpayer's cost of acquiring the replacement qualified housing projects. (*Id.*)

The Report of the Senate Finance Committee on this provision stated:

> General reasons for change. – In the case of federally assisted housing projects (where the return to the investor is limited to approximately 6 percent), the Government is interest in encouraging the sale of these Government-assisted

> housing projects to the lower income occupants or to a tax-exempt organization which manages the property on their behalf (such as cooperatives or condominiums). The maximum sales price permitted under these programs under present law is the amount the individual has invested in the property plus an amount necessary to retire the outstanding mortgage liability and the taxes payable as a result of the sale. By providing that no gain is to be recognized in these cases, it would be possible to decrease the sales price to the occupants or tax-exempt organizations managing these properties. The committee believes this result would be desirable. This should enable them to make purchases they otherwise could not make. . . . (Emphasis added.) S. Rep. No. 552, 91st Cong., 1st Sess., reprinted in 1969 U.S. Code Cong. & Ad. News 2027, 2330.

Thus, to be eligible for this incentive, there could be no economic gain on the sale.

Capitalization of Construction Period Interest and Taxes

In the Tax Reform Act of 1976, Section 189 was enacted to provide for capitalization of construction period interest and taxes. As originally enacted, Section 189 was not to apply to low-income housing until tax years beginning after December 31, 1981. However, the Economic Recovery Tax Act of 1981 amended Section 189 to exclude low-income housing on a permanent basis.

The General Explanation of the Economic Recovery Tax Act of 1981, prepared by the staff of the Joint Committee on Taxation, stated the reason for permanently exempting construction period interest and

taxes with respect to low-income housing from the application of Section 189, as follows:

> To attract capital for the construction of low-income housing, the Congress decided to exempt low-income housing from the rule requiring capitalization and amortization of construction period interest and taxes. Staff of Joint Comm. On Taxation, 97th Cong., 2d Sess., General Explanation of the Economic Recovery Tax Act of 1981, at 176 (Comm. Print 1982).

Declining Balance Method Depreciation

In 1981, when Congress enacted new depreciation methods and periods under the ACRS system, it generally limited depreciation in regard to real property to the 175% declining balance method, with a switch to the straight-line method. However, Congress authorized 200% declining balance depreciation in regard to low and moderate income housing. This additional depreciation applied both to new low and moderate income housing projects and to such projects bought on a used property basis.

In other rulings, the IRS characterized Section 236 subsidy payments in a manner which increased the project owner's up front tax losses. See Rev. Rul. 76-75, 1976-1 C.B. 14, holding that Section 236 interest payments (a predecessor to Section 8 payments) are includable in owner's gross income, but deductible as interest. The applications for the above rulings—supported by state and local housing agencies—made it clear that the only reason for investment in these projects was the potential tax savings).

EXHIBIT I

MECHANICS OF BUILT IN TAX ON SALE OR FORECLOSURE

1. Upon any transfer of the project (similar to the transfer of any other type of rental property), the transferor would realize gain equal to the excess, if any, of:

   (a) the amount realized, representing the sum of: (A) any cash and note proceeds received, and (B) the mortgage and other accrued liabilities on the project, over

   (b) the adjusted basis for the project (that is, the acquisition cost less accumulated depreciation).

2. Under the foregoing rule, the transferor would be deemed to realize gain on a transfer in excess of any proceeds in cash and notes actually received on the transfer. The excess gain represents the excess of the mortgage and other liabilities on the project over the adjusted basis. The excess is often referred to as a "phantom gain."

3. The phantom gain may result in tax to the Partnership, even in the event that no cash or note proceeds were received (*e.g.*, on a foreclosure), and in many cases, the tax on a transfer would be in excess of any cash and note proceeds received.

4. The gain on the sale or other disposition would be taxed as Section 1231 gain (generally treated as capital gain), except to the extent of any depreciation recapture under IRC § 1250. The depreciation recapture amount would be

ordinary income. After a specified holding period, a portion of the taxpayer's gain on the sale of the property would be taxable as long term capital gain, that is, at a rate lower than the rate of tax savings from the original losses;

5. Upon any transfer of the project, it was likely that the investors would not receive back the investors' equity - and indeed the projections furnished to the investors by the Partnership ended with a foreclosure of the project on which the investees would owe an out of pocket.

6. To the extent that the gain realized on a transfer is taxable as capital gain, there would be a long term net tax saving, that is, the excess of: (a) the tax saved on the current deductions against ordinary income (taxable at *e.g.*, 35%) over (b) the tax incurred on the transfer (taxed at capital gain rates of 15% and 25%).

7. To the extent that ordinary income is realized on a transfer, the investor's long term tax saving would represent only a deferral of tax.

EXHIBIT J

EXCERPTS FROM CONGRESSIONAL AND OTHER REPORTS ON TAX INCENTIVES

In regard to the Tax Incentives enacted for low and moderate income housing from 1968 to 1981, this Exhibit includes excerpts from the relevant Kaiser Commission report, Congressional reports, and Congressional hearings.

These excerpts show the total awareness and understanding of both Congress, the executive branch and the private sector of the following:

(1) the development and management of government assisted and regulated low and moderate income housing involved major work risks not involved in other real estate development;

(2) apart from the Tax Incentives, there was no economic return or hope of profit from an investment in low and moderate income housing, and, therefore, private enterprise would not undertake the development of such housing,

(3) Tax Incentives were offered by Congress consciously with enthusiasm, as a means of involving private enterprise and capital in the development of low and moderate income housing,

(4) the Tax Incentives worked by the offsetting of losses from the project against the investor's other income, resulting in substantial savings of tax to the investor, and

(5) a tremendous volume of low and moderate income housing was being built based on the

Tax Incentives, which would not have been built in the absence of those incentives.

I. 1967—The Kennedy Bill

As set forth in the text, the concept of offering Tax Incentives for investment in low and moderate income housing was first given major public attention by Senator Robert Kennedy's bill (S2100), introduced in 1967. The hearings on the bill showed support for the concept from many diverse parts of the community, including Congressmen, local governments, builders/developers, black groups, economists and academia.

At these hearings, the witnesses emphasized that investment in low income housing had no economic return, and that this fact was widely understood by builders and others in the private sector. Accordingly, Tax Incentives were necessary in order to cause the private sector to develop this type of housing.

The witnesses emphasized that low income housing efforts by the government and non-profit groups had failed in many respects, and that, accordingly, Tax Incentives for the private sector were the sine qua non for solving the problem.

Excerpts from the testimony are as follows:

Senate Finance Committee, Hearings on Tax Incentives to Encourage Housing in Urban Poverty Areas, 90th Cong., 1st Sess. (1967).

A. Testimony of Senator George A. Smathers (p.55):

"The remedy to poor housing through direct Government assistance has been tried and it has been found wanting. As yet, a

workable alternative to public housing for low-income groups has not been found.

Private developers have not wished to engage in low-income housing construction because there has been little, if any, profit in it. Quite naturally, the American businessman expects the maximum profit—at least a fair profit—from his investments; Unfortunately, by itself, building private housing for the poor offers no such profit.

Since this is the tax-writing committee in the Senate, it is appropriate that the bill be before us and that we discuss its tax provisions. The principal Tax Incentives provided by the bill to developers of low- income urban housing are, first, the tax credits, and second, the reduced depreciable life of these properties."

* * *

C. Testimony of Randolph A. Rouse, a leading developer (p. 203):

"MR. ROUSE. I don't think anybody knowing anything about the building business would question for a minute that, if you started out with the Government to build a million dollars worth of housing that it was going to rent under the public housing program, or it was going to provide tax inducement to business to make $1 million worth of housing, that more and better housing would be produced by this route than with the expenditure of a million dollars of Government money.

This can induce competitive innovation and the use of new materials, design, and techniques. There will be industrial corporate pride at stake in this."

D. Testimony of C. Douglas Dillon, former Secretary of the Treasure (pp. 222, 228):

"In conclusion, I am firmly of the opinion that we cannot solve the urgent problem of our cities unless we tap the huge resources of our private enterprise economy and harness its ingenuity and energy in pursuit of a solution.

So I favor any and all approaches that are designed to accomplish this end. Specifically, in spite of the arguments of general tax policy against the creation of new and special exemptions, and they are valid arguments, I would favor the use of tax policy wherever other tools cannot do the job. This seems to be clearly the case in the field of job creation covered by S.2088 and may well prove to be the case in the housing area as well.

* * *

SENATOR KENNEDY. Mr. Secretary, the question has been raised whether it would be equally effective to seek industrial investment in the ghettos through an appropriation or a payment to a businessman to invest in the ghetto, to build housing in the ghetto, or build a factory in the ghetto. This would be a place of a tax incentive.

Would you comment on that?

MR. DILLON. Of course, if he actually received the same amount of funds, the result would be the same. But there is a great difference. I think our national position is very heavily against subsidies to business of that nature, and I don't think business people like them, or they don't believe they would be able to count on them. They could be voted one year and they might not be voted the next year.

Therefore, there is no certainty that they would continue. There is more certainty that a tax incentive would be allowed to continue because people would make the investment with that in mind. It wouldn't be so likely that it would be drastically changed in midstream." (emphasis added)

It is important to note that former Secretary Dillon's testimony emphasized that the businessmen would rely on Tax Incentives because of their believed stability.

E. Testimony of Mortimer M. Caplin, former commissioner of Internal Revenue (pp. 252-253):

"SENATOR SMATHERS. Mr. Commissioner, it has been a fact, has it not, that up to this point private business has not been willing to go into the ghetto areas and build houses for the poor?

MR. CAPLIN. This is the major problem facing the Nation.

SENATOR SMATHERS. Is the reason that they have not done this because there apparently has not been sufficient financial incentive for them to do it?

MR. CAPLIN. That is right, sir. I might add that I happened to be appointed by the federal court in New York as trustee in the reorganization of Webb & Knapp, the famous Zeckendorf enterprise. Efforts were made in the early stages of Webb & Knapp to get them interested in construction in ghetto areas. Webb & Knapp is in dire financial condition today, but at one time was one of the great real estate ventures of the Nation. While they did move into some of the poverty areas, they were not able to take a major role.

SENATOR SMATHERS. Because there is not sufficient profitability.

MR. CAPLIN. No profitability. Business must function for profit.

SENATOR SMATHERS. After the bill is amended, and assuming everything Senator Williams has said, do you think there will be enough incentive to private business to go into the slum areas and build houses? That is the purpose of the bill.

MR. CAPLIN. This is a judgment factor, Senator. I think the expressions of the people who are sophisticated in this industry are paramount. I will say, as a practicing attorney, that in talking to real estate clients and talking to businessmen, they find this one of the most imaginative, creative pieces

of legislation that they have encountered in this area, and they feel that there is room in which they could make profit and make a contribution.

I think that would be the ideal, to use the resources of our free enterprise system." (emphasis added)

F. Testimony of Curtis M. Berger, Professor of Law, Columbia University (pp. 326, 328):

"SENATOR SMATHERS. You passed the course and you are out. So, independently, can you say from your own observation and study of the bill whether you believe there is any windfall?

MR. BERGER. I do not believe there is any windfall.

It has also been argued that the 221(d)(3) below-market interest rate will provide a comparable return to the limited-dividend sponsor during the first years of his investment. But do not be misled, and certainly few potential investors will be misled, by the deceptiveness of that return.

Like the wisp of smoke, it will eventually disappear as the mechanics of tax accounting convert a paper loss into a paper profit, and the property owner is taxable on more income than he actually receives.

I will not labor you with either the theory or computation which explains this. There is already in the record a very elaborate exposition.

What it comes to is that the investor in a BMIR 221(d)(3) project really cannot hope for much better than the 8 percent return under the best of circumstances.

I do not believe that this is a sufficient return to be inviting to the private investor.

SENATOR SMATHERS. Is it not a fact that that is not high enough to make them invest their time and money in areas where they are liable to be subjected sometimes to difficult tenants, riots, and violence, and a lot of other disadvantages which they would not incur if they spent their time and money out in suburbia?

What you are saying is that there is not enough incentive; is that not correct?

MR. BERGER. Exactly. An 8-percent return is insufficient incentive. Let me give you an analogy. Six or 7 years ago, in the late 1950's and early 1960's, real estate syndication became a prevalent form of investment in New York City and some other larger cities throughout the country.

I think we have begun to realize that the traditional methods of producing housing in slum areas and the traditional incentives that we have provided are simply insufficient. The public provided are simply insufficient. The public agencies and the charitable agencies cannot do the job themselves." (emphasis added)

G. Testimony of Whitney M. Young, Jr., Executive Director, National Urban League (p. 333):

"In short, through its system of Tax Incentives, mortgage arrangements and by establishing a competitive rate of return, the Kennedy proposal is designed to attract sophisticated money into the rebuilding of the Nation's ghettos.

I am prepared to say that there will be no real breakthrough in the solution of our urban and racial problems until the private sector recognizes the full extent of its stakes in our current social crises and until money from major sources is attracted into the ghetto in large amounts to do the massive job that only massive, privately generated moneys can do.

The provisions whereby individuals and corporations would be permitted to pool their resources and allowed to pass rental income and tax losses through to their shareholders are important for a number of reasons.

If it is true that the American economy works because everyone owns a share of it, then it is fair to assume that the broader the American investment in the ghetto the greater the sensitization of the American people to what goes on in the ghetto, a development which, while indirect in terms of the formulation of this bill, can only be good."

H. Testimony of James Tobin, Professor of Economics, Yale University and later member

of President's Council of Economic Advisors (pp. 342, 343):

"From a social point of view, there can be no question that investment in low-rent urban housing is woefully inadequate. Private investors do not find the profit prospects attractive, but these prospects do not, of course, include the benefits of improved neighborhoods to the whole community—in architecture and esthetics, in public health and sanitation, in reduction of crime and delinquency.

Moreover, a simply investor may be discouraged by the apparent hopelessness of the task—he cannot remake a neighborhood alone. But if several residential investments are undertaken simultaneously they will reinforce each other and alter the whole "tone" of the neighborhood.

Still another reason for low private investment is reluctance to assume unusual risks of property damage, arrears in rental payments, turnover, and vacancies. These risks are formidable for the individual, but much less costly when pooled over a large number of undertakings. It is entirely proper for Government to arrange this pooling and to help individual investors bear the risks.

In addition to its intrinsic handicaps, urban low-rent housing suffers in a relative sense from Government programs that tend to encourage suburban expensive housing. Mortgages are insured; special financial in-

stitutions to make mortgage loans are fostered; homeowners are allowed to deduct mortgage interest from taxable income, while receiving the yield on their investments in nontaxable form.

I certainly do not favor promiscuous use of Government subsidies of any kind—whether outright payments, tax credits, accelerated depreciation, or interest subsidies.

There are a number of such subsidies in existence which seem to me to have little justification, and there are many plausible proposed subsidies or Tax Incentives which I would recommend that you deny.

I can therefore understand the concerns of those who are trying to defend the tax base from erosion and the public credit from excessive use on behalf of private borrowers. But if ever a cause justified the suspension of these principles, we have it here and now in the overriding national importance of urban low-rent housing." (emphasis added)

Hence, Mr. Tobin, like Mr. Berger, a dedicated long-term opponent of Tax Incentives, supported their use for low and moderate income housing as not merely appropriate, but absolutely necessary to get the job done.

I. Testimony of Edward J. Logue, former Administrator of Boston Redevelopment Authority (p. 356):

The experience that we have had over the years in trying to get the affluent to improve conditions among the poor in America have been

permeated with an atmosphere of righteous charity. This kind of "do-goodism" has given a lot of well-intentioned people a lot of credit lines for civic service but it hasn't made much of a dent in the problem.

Furthermore, when we grudgingly get around to encouraging investment in the ghettos we tend to make the profits as slender and difficult to get as possible, and the administration of these programs, once enacted, time and time again has attempted to make them as unprofitable and complicated as possible.

II. Kaiser Commission Report—1968-69

The Report of Kaiser Commission—President's Committee on Urban Housing, a Decent Home (1968-1969) set forth the need for greater incentives to involve private industry in the development and operation of low and moderate income housing. It stated as follows:

"A. Involving the Private Sector in Subsidized Housing Programs

The principal charge to this Committee was to find the necessary incentives and mechanisms for attracting more private participation in the development of subsidized housing. The national goal of six million additional subsidized dwellings over the next 10 years represents nearly an eightfold increase in the subsidized stock developed over the past 30 years. We are convinced that attaining such a goal depends on full participation by the profit–oriented private sector, as well as by nonprofit and local public institutions.

> The nation's homebuilding industry, except during the economic constraints of wartime and other adverse conditions, has demonstrated its capability to meet the market's demands for housing. The private sector has not yet developed much housing for the poor because until recent years the subsidies required to make such efforts feasible and reasonably profitable have been lacking in scale and attractiveness". (p. 15)

The report went on to recommend that Tax Incentives be the mechanism for creating a sufficient profit to involve private industry in the program. The report stated:

> "It may be that experience will show that the most broadly effective solution to the above problem will require another approach. If so, the Committee makes two recommendations in this area:
>
> First, the Committee recommends that a 3 percent tax credit be extended to limited distribution mortgagors (sponsors) on the completion of a low-or moderate-income housing project. This tax credit would be identical to that now available for companies placing into service public utility equipment and machinery. It would be less than the 7 percent investment tax credit available for the construction of buildings. The 3 percent tax credit, even with the existing tax treatment on sale, would appear to provide for a realistic level of profitability without the necessity for a rent increase or an extension of mortgage term upon sale.

As a second alternative approach, the Committee recommends the use of a tax forgiveness if the project is sold to a tenant's cooperative or nonprofit group.

All the above proposed approaches would have the advantage of encouraging developers to form tenants' associations and to assist them in gaining the experience and skill needed to manage and own their own housing. Early sale to such a group would achieve many of the desirable social objectives of homeownership by lower-income families, while allowing the builder-sponsor to free his capital and management skill for construction of other needed subsidized housing." (p. 17)

The Committee then went on to propose the formation of the National Housing Partnerships (later done) to raise investment funds for low and moderate income housing based on the Tax Incentives. In this regard, the Committee stated:

"National Housing Partnerships

The Committee received indications from surveys conducted for us that a lack of technical knowledge and a reluctance to own Federally subsidized housing projects for the poor are major reasons why big business has been slow to enter this segment of the housing market. The Committee was concerned, moreover, by the fact that no current participants in this market are large enough to serve as laboratories for new and exiting programs and to measure definitively the possible economics of scale.

For these reasons:

The Committee recommended to the President the creation of a new private instrument—the National Housing Partnerships—to permit firms not now engaged in the subsidized housing field to come into it on a sound business basis.

This recommendation was enacted into law as title IX of the Housing and Urban Development Act of 1968." (pp. 17-18)

The Report advised Congress and the public just how the Tax Incentives would work. It states:

"The partnership form was chosen to permit the passing through of book losses (resulting from depreciation and other deductions) to individual investors." (p. 18)

Tax Savings

While Federal regulations limit cash returns, the owner of a subsidized housing project is entitled to take normal depreciation deductions on project development cost (excluding land) in calculating his Federal income taxes. Moreover, under existing tax law, depreciation may be taken in various accelerated forms so that deductions are greater during the early years of project life. A 1964 amendment of the Internal Revenue Code provided that some or all of the benefits of accelerated depreciation are recaptured . . . Other tax deductions are also available in early years. If a project is owned by a partnership, individual and corporate partners can obtain the benefit of the partnership's tax losses. Each investor may use these book losses to offset other income in computing annual taxes.

Thus, while the cash yield by itself may not be impressive, a Federally subsidized project may be sufficiently 'profitable' to an investor who can offset other income with substantial book losses, thus reducing the amount of tax currently payable." (pp. 82-83.)

The Commission report then went on to provide a detailed example of:

(1) how the Tax Incentives works (by effort of the tax losses generated by the project against the investor's income),

(2) how the Tax Incentives provide substantially all of the investor's yield even if the maximum permissible cash distributions were made (they rarely are), and

(3) how the predominance of the tax savings are "repaid" on a sale, making the incentives largely a deferral rather than a permanent saving.

The report stated:

"Total Yields

Ignoring for the moment the tax consequences of sale, the total annual return—net cash income plus tax savings—available to taxpayers in various tax brackets is shown in Table 2-6. The table shows both the cumulative average return on equity ("average") and the discounted return ("dis"). The discounted yield takes into account the time when the return is received. Since income is higher in the early years and available for reinvestment, it is more valuable, and, therefore, the discounted yield computation would exceed average yield.

While the yield shown in Table 2-6 appear to be reasonably attractive, at least in the earlier years when tax savings are highest, the table does not reflect the serious impact upon those returns of the tax consequences of the sale of a project. In the year of sale the seller is required to pay taxes on the difference between the sales price and the depreciated basis of the project. Furthermore, depending on the length of time the property was held by the seller, some portion of this amount may be taxable as ordinary income.

The taxes on sale diminish the established yields substantially. Appendix H-3 shows the amount of tax payable on the sale of a project after various holding periods: the sale price is assumed equivalent to the unamortized mortgage amount which would be outstanding if the project had originally had a 100 percent mortgage (3 percent interest rate for 40 years). The effect on yields of the tax payable on sale is presented in Table 2-7 for taxpayers in the 50 percent bracket.

The tax consequences of the sale of the project seriously diminish the attractiveness of the investment since many investors seek a discounted after-tax return of at least 15 percent. It is apparent that the tax on sale may reduce reasonable returns in the early years to unrealistic levels and also reduce the previously marginal long term yields.

Because of rising real estate values, the tax consequences of sale are minimized in the conventional housing market. Profits from the sale are available to pay the taxes. However, under past FHA proce-

dures this solution is not available to owners of subsidized projects. Regulations have prohibited refinancing for 20 years and sale has rarely been permitted to a subsequent owner without loss of subsidies on the project.

Table 2-6. Cumulative Average After-tax Yield-(including 6 percent cash return and tax savings) on Investment $408,0001(1)(d)(3) below market interest rate project) for investors in 30, 60 and 70 percent Bracket covering Tax Consequences on sale.

Years before Sale(2)	Yield for taxpayer 50 percent bracket: Annual return (2)	Dis.(4)	Average return (3)	Yield for taxpayer 50 percent bracket: Annual return (2)	Dis.(4)	Average return (3)	Yield for taxpayer 70 percent bracket: Annual return (2)	Dis.(4)	Average return (3)
1	$77,000		18.9	$128,000		31.4	$179,600		44.0
2	78,600	14.5	14.2	64,800	24.4	23.6	90,100	37.7	33.1
3	69,800		13.5	66,800		21.1	93,400		28.8
4	46,900		13.0	61,800		19.7	76,700		26.3
5	61,100	12.9	12.6	57,200	19.9	18.5	70,200	27.4	24.5
6	59,700		12.1	49,900		17.3	60,000		22.8
7	57,100		11.7	42,500		16.6	48,200		21.5
8	54,600		11.3	41,400		15.8	42,500		20.3
9	52,200	11.3	10.9	37,400		15.0	37,600	23.2	19.2
10	29,900		10.5	33,500	16.8	14.4	31,700		18.2
11	27,600		10.2	29,700		13.7	26,600		17.2
12	25,400		9.9	26,900		13.1	21,600		16.3
13	23,300		9.5	22,400		12.5	21,600		15.5
14	21,300		9.2	19,000		12.0	16,800		14.7
15	19,200	10.2	8.9	15,600	15.0	11.4	12,100	21.2	13.9
16	17,200		8.6	12,300		10.9	3,600		13.1
17	15,300		8.3	9,100		10.4	3,000		12.4
18	13,500		8.1	6,100		9.9	(1,400)		11.7
19	11,600		7.8	2,900		9.4	(5,300)		11.0
20	9,800	9.4	7.5	(300)	13.8	8.9	(9,000)	20.0	10.3

(1) if real equity is less than $408,000, yields would increase proportionately. Assume that return is received annually, that entire equity investment must be made at the beginning of construction.

(2) Assumes one-year construction period and one-year break even period.

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(3) "Annual Return" is the sum of column A (net cash income) plus applicable column B, C, or D (tax saving) in the table in Appendix H-2.

(4) "Dis" represents the average cumulative rate of return on the $408,000 equity, discounted in accordance with accepted financial practice.

(5) "Average" represent the average cumulative rate of return on the $408,000 equity, not discounted.

In acting on the Committee's recommendation, the President said in his February 1968 message on The Crisis of the Cities:

> "I propose that the Congress authorize the formation of private funded partnerships what will join private capital with business skills to help close the low-income housing gap'.
>
> The Kaiser Committee identified three principal reasons why American industry has not yet been attracted to the field of low and moderate income housing. The problems and the steps proposed to meet them are:
>
> * * *
>
> 2. Rate of Return
>
> Substantial operating losses are usually incurred in the first 10 years of housing project's life as the result of operating and interest expenses and depreciation.
>
> Under existing law the partnership form of organization, now used by some building owners permits these operating losses to be 'passed through' to each investor, and used by him as an offset against his other taxable income. This reduces current income taxes otherwise payable,

and makes possible an annual cash return on investment comparable to the average earnings of American business in other manufacturing enterprises." (p. 86) (emphasis added)

III. Tax Reform Act of 1969

Hearings on the Tax Reform Act of 1969, Senate Finance Committee, 91st Cong. 1st Sess. (1969) and Hearings on the Subject of Tax Reform, House Ways and Means Committee, 91st Cong., 1st Sess. (1969).

In the Treasury proposals (before the Senate Finance Committee) which led to the Tax Reform Act of 1969, the Treasury proposed:

A. cutting back the acceleration of depreciation for commercial property and used residential property;

B. at the same time, retaining existing accelerated depreciation rates for new low and moderate income housing; and

C. 5-year amortization of expenditures for the rehabilitation of low and moderate income housing (which proposal became Section 167(k), set forth in the Report.

The Treasury Report indicated that the rationale for the retention of accelerated depreciation for low and moderate income housing was that in the absence of Tax Incentives, there was no economic return to induce such high risk investments. Witnesses at the hearings before the House Ways and Means Committee stated that given the risks and difficulties of ventures for the development of low and moderate income housing, more incentives were needed, and that a cutting back of the incentives would mean an end to this type of development.

Excerpts from the hearings are as follows:

A. Statement of Robert H. Pease, Mortgage Bankers Association of America (pp. 2773-2774):

"I recently had a folder on a tax-free industrial bond from Scottsboro Ala. In a sense, this is guaranteed by Revere Cooper and Brass via the process of a lease for the entire term of the loan.

This is a 6-pcercent tax-free bond to 1990. Now, for a man in the 70-percent tax bracket, that is a yield of 20 percent.

You cannot attract money into real estate in competition with this kind of investment in today's market, I believe.

I tell you that we are now committed on a national basis to the greatest housing program in the history of the country. One of the finest, probably the finest housing Act that has ever been written was the 1968 Housing Act.

I don't know how we can possibly begin to accomplish what that Act calls for, unless private capital is attracted into the field. Look at the National Housing Partnerships Act, for example. You certainly cannot expect that to succeed without the benefits of accelerated depreciation, because private capital will not be attracted into the field.

The entire program of HUD is predicated on private funds for the housing market. My personal opinion is that without accelerated depreciation, these objectives could not begin to be accomplished.

I think you are faced with a dilemma. If you want private enterprise to participate in housing, you have got to continue the incentives which is has in order to do it.

I know you are disrobed by wealthy people paying no tax, and I could not agree with you more. I am disturbed, too. But I think that you are putting the emphasis in the wrong place.

This thing deserves correction, but it does not deserve correction at the expense of our vast housing program. To me this is the objective, how to do both jobs.

I assure you that in my opinion, they can be done. I believe that in many cases you will find that private participation in housing is now, as it was in the past, dependent on the ability of attracting capital into a field where many people really don't want to take part, and there must be accelerated depreciation or they will not be brought in." (emphasis added)

B. Statement of Arnold L. Karp, President, Karp Nestler & Co., member of Low Income Housing Committee of National Association of Home Builders (pp. 2792-2793):

"Developers, builders, and packagers of low-, moderate-, and middle-income housing, and these are primarily in the FHA programs, must attract private capital for both seed money and equity in order to get a project off the ground. In recent years, because of the increased cost of money for interest, discount, service charges on construction loans, as well as the increased cost of ground, the equity ra-

tios have risen substantially. By necessity, it is meant that a larger and more sophisticated equity investor must b sought for these projects. To attract this type of capital it is necessary to go to individuals in the higher income brackets, investment houses, and large corporate partners which can use the tax benefits that these projects offer. In ferreting out this capital in the market, the developer is competing against other investments which offer competitive benefits and yields. It is somewhat analogous to what has happened in the past 2 years with the mortgage market where the investment funds have been competing with the bond market. When the bond market offers more attractive yields and liquidity, the mortgage market dried up. If so-called loophole closing efforts are applied strenuously to the housing field, more so than to other competitive investments, it would curtail the flow of resources and managerial efforts in this area. Tax equity and productivity must be carefully tempered in the light of these considerations.

It should be evident that the job of attracting this capital is that much more difficult. As a sidelight we have found that recently, because of the increased equity requirements in these FHA programs, that the investors who formerly were coming in at the final closing when the buildings were completed are now requiring that they come in at the initial closing in order to take advantage of construction losses.

In order to consider the problem of what benefits or incentives are necessary to produce

low- and moderate-income housing, some consideration should be given to what risks ad requirements are necessary to produce this housing. In every real estate venture, the infusion of risk capital is weighed against the possible return on the project.

It has been difficult to raise seed or front money from investors and much of the housing presently built has relied on builders who warehouse ground. It has been necessary to establish grants and revolving development funds as further incentives for developers and sponsors to get involved. The projects which have been sponsored by

"House solution. The House bill revises real estate depreciation (the 200 percent declining balance and sum–pf-the-years digits methods) are limited to new residential housing.

* * *

Arguments For. (1) This provision strikes a good balance between the need to curtail the availability of the real estate provisions as a tax shelter and the need to provide adequate incentives for the building of low income housing."

C. The hearings included the following statement by the Treasury Reports.

D. Appendix A. Technical Memorandum of Treasury Position (p. 111):

Treasury recommends further that the recapture rule of existing law be retained without change for certain Federally-assisted projects under the so-called FHA 221(d)(3) and

FHA 236 programs. These programs provide a limited return to investors of 6 percent, this low rate of return having been based on the existing favorable tax treatment. It is inappropriate to change this treatment unless and until Congress acts to increase the allowable return."

IV. 1973 Proposals for Tax Reform

In 1993, hearings before the House Committee on Ways and Means, one of the proposals considered was a limitation of rental property deductions to the equity in the project. The testimony was that any such limitation would cut off investment in low and moderate income housing (Hearings Before House Ways and Means Committee), 93rd Congress, 1st Sess. (1973) pp. 3113-3157).

A. March 26, 1973, Submitted Statement of Howard Benedict, Vice Chairman, Federal Taxation Subcommittee, and J.D. Sawyer, President, National Association of Realtors, accompanied by Edwin Kahn, Special Tax Counsel (at pp. 3121, 24)

"Proponents of an equity limitation on the depreciation deduction claim that the use of financing for real estate development constitutes a 'loophole' because it results in a taxpayer's reduction of his tax liability for one or more particular years, and this reduction may be recouped if the property is disposed of at a gain. They do not refer to the many cases where the property is sold at a loss. Often, these losses are not only tax losses, but are real out-of-the-pocket cash losses of the owner.

* * *

> Much public notice and concern has been focused in the past few years on the public sale of so-called 'tax shelters'. The overwhelmingly large percentage of these offerings have been based on the sale of an interest in a subsidized housing project. In order to produce very low rentals, these projects were intentionally designed ass uneconomic projects with the only inducement for private-sector purchase being the Federally encouraged tax loss provisions." (emphasis added)

The discussion between Mr. Benedict and the Committee (at pp. 130-36) included the following:

> "I attended the previous panel held approximately a month ago. The vast majority of the adverse comment son syndication related to subsidized housing. I submit this is not a typical economic real estate project. It was not designed to produce the type of profit that is customary and necessary to encourage widespread ownership.
>
> In 1968, we had a national housing problem. We were badly underhoused. We couldn't charge full rates because the tenants couldn't afford the rentals in these projects. So the subsidized housing programs were designed with extremely limited income potential, very limited appreciation, and the only thing that made these salable to a broad spectrum of the private economy were their tax benefits. . . .

REPRESENTATIVE ULLMAN: (at 3135)

> Is there any way that you could suggest that we could maintain the legitimate incentives for real estate investment, but still put some limita-

tions on the investor's ability to write off ordinary income in a rather massive way?

MR. BENEDICT. Mr. Ullman, I think that you did accomplish a great deal of that in 1969 with the present recapture rules. Let me respond perhaps in a different fashion.

If that same individual [who applied passive losses from low income housing against other income] was to buy Polaroid stock, he gets virtually no dividends from that stock. So why should he buy it? It is essentially uneconomic in dividends. He does because that company is taking its dividends and plowing it back in so that the stock will go up and he will get long-term capital gain.

I detect that if that individual that you speak about took the risk in subsidized housing, he would get a similar type of thing except he gets no dividends and has virtually no chance of capital appreciation.

What then is there left to this man to encourage him to go into some of our cities and take the very substantial risk that is involved?

I submit that the Congress designed certain tax losses as an exchange for the economic benefits that the property would normally give. You now have lower rents in exchange for the tax benefits that result from the tax losses.

* * *

MR. ULLMAN. Well, I think all of us have some grave concerns about some of the subsidized programs that we have gotten into. But isn't one of the reasons that we have begun these programs, the fact that it is virtually impossible,

even with the existing incentives, to come up with any kind of programs that will satisfy the housing needs of the low income people.

. . . (at p. 3136)

The thing that bothers me is that the program was designed or built around the tax advantages that we purposely had put into real estate. Therefore, you produced a lot of noneconomic investments. After the tax benefits have been received I wonder what you are going to do with a lot of noneconomic housing.

MR. BENEDICT. Well, I have to say again that I don't believe that private enterprise can build economic housing of the quality that these people have a right to expect for the rents that their present income levels can afford, in the very high risk areas where you often find these people living, rents that will pay the type of return that real estate outside of the city or in other areas would give." (emphasis added)

B. Statement of Albert Walsh, President, National Realty Committee, Inc.; Accompanied by Louis Kaster, General Counsel (at p. 3187):

> "Perhaps because it is essentially an industry of small business units, and because the decision to invest in real estate is always highly discretionary, real estate is unusually susceptible to even small changes in tax policy.
>
> Thus, the relative tax advantage afforded to low- and moderate-income housing in 1969 did result in a flood of capital into these fields and did produce all time records of housing production and rehabilitation. Whether or not the

specific housing programs involved were well designed—or well administered—is a matter for other committees of this Congress, but there can be no denying that the real estate industry did react dramatically to the relative incentives provided and major shifts of investment capital did occur.

There also can be no denying that if the relative incentives provided in 1968 are removed, another major shift of capital will occur, and the production of privately owned low- and moderate-income housing will cease or be curtailed dramatically."

The written statement submitted by Mr. Walsh stated (p. 3139):

* * *

"Builders and developers will, of course, continue to build wherever and whenever they can, but, as even the `experts' concede, the rate of return to potential investors will have to be increased in order to compensate for any new tax disadvantages and to compete with alternative investment opportunities. Where the market is strong, these increases will initially be passed onto the tenant or purchaser in the form of increases costs or rents and, in the case of industrial or commercial property, ultimately to the consumer in the form of increased costs for goods and services. In the case of conventionally financed housing, for example, which continues to be the prime source of housing for at least 80 percent of our population, elimination of accelerated depreciation and/or the deductibility of interest

during construction would result in rent increases of between 10-30 percent, depending on the precise circumstances.

If the market will not absorb these increased costs or rentals, which is certainly the case in many areas as far as housing is concerned, the proposed development will simply not be built, with all of the consequent losses of jobs, national income and gross national product.

. . . (p. 3194)

A recent HUD study, by Touche Ross & Co., of 137 investors and investor groups, confirms that the existence of current tax rules is one of the most important considerations in choosing to invest in multi-family housing. When subsidized low or moderate income housing is involved, Tax Incentives become a deciding factor. The study cites a number of factors which would seriously discourage investment in low and moderate income housing in the absence of the current, or equivalent, Tax Incentives. They include: high maintenance and replacement expenses; low appreciation in value; difficulty in selling; government bureaucracy and red tape; high collection losses; and low (or non-existent) cash return. From my own 14 years experience in the field of government-assisted housing, I would add a few more: the long, and expensive, planning and processing period; the expensive, planning and processing period; the controversial and sometimes highly political nature of many such projects and their high mortality rate.

. . . (p. 3204)

PROPOSAL

Certain deductions incurred in connection with real estate investments would be limited to the income derived from such investments.

COMMENTS

In computing a taxpayer's net income, deductions incurred in any transaction entered into for profit may, under existing law, generally be offset against income realized from any source. Limited exceptions to this general rule exist with respect to investment interest and certain farm losses.

Currently, our income tax system generally imposes a tax upon a taxpayer's net income from all sources. The proposal is undesirable since it would distort this computation of total net income and substitute a hybrid system in which the tax base would be income from all taxable sources, after subtraction of some (but not all) related deductions.

In its ultimate effect, the proposal would create further tax inequalities by favoring wealthier taxpayers with substantial real estate investment portfolios over taxpayers making occasional investments. It (the proposal) discourages participation by new investors in projects which would not initially generate sufficient income of the type required to offset the otherwise deductible expenses incurred. It, therefore, inhibits discretionary investment in higher risk real estate ventures and would virtually eliminate investments in low-income housing.

> The proposal would have particularly harsh effects with respect to taxpayers who were unfortunate enough to make bad investment decisions, resulting in actual substantial economic losses." (emphasis added)

In discussion with the Committee, some of Mr. Walsh' relevant statements are as follows (pp. 3213-14).

> "I think there is always, as I indicated, a competition for the available supply of capital; that competition is more between real estate and alternative forms of investment.
>
> The typical low-income housing project, 235 or 236, is a very high risk investment indeed for a number of reasons, some of which I detailed in my formal statement, some of which have to do with the length and difficulty in planning and processing, the number of governmental agencies which have to be dealt with, some of which have to do with the nature of the tenancy, some of which have to do with the nature of the tenancy, some of which have to do with the of the tenancy, some of which have to do with the political nature of the site selection process and the high mortality rate on many such projects; they abort long before they get to the point where they can produce any income, but after substantial investments are made.
>
> I think the money that has flowed into that kind of housing has not diminished capital available for conventional housing projects and really has come from a very different source, and apparently was intended by the Congress to come from a source of investors who have been called

here today and other days `passive,' `tax shelter-motivated,' et cetera.

At least I have assumed that that was a result intended by the Congress in providing the relative advantages in 1969." (emphasis added)

C. Statement by George Martin, President of the National Association of Home Builders (at pp. 3237-38):

"Many provisions of the existing Federal income tax laws are intended to, and in fact do, encourage the construction of residential rental housing for families of all income ranges. In fact they are, in conjunction with the various Federal housing subsidy programs, the principal, if not the sole, mechanism whereby housing can be constructed and owned by private enterprise for low and moderate income families. Accordingly, we are concerned that enactment of significant changes in these provisions would seriously impede the flow of necessary capital into the construction of rental housing. This would reverse the pattern of significant increases in construction of new multifamily housing since the 1969 Tax Reform Act, and adversely affect our ability to meet the nation's housing needs in the years ahead. Moreover, it could result in a substantial increase in rentals for the housing which is produced and thereby increase rental levels generally. Such results would be contrary to the national policy, increasingly stressed by the Congress over the last 39 years, to encourage the construction of necessary housing.

We believe that the policy of encouraging the construction of necessary housing through the provision of incentives is one which Congress should continue to foster in the national interest. In view of the recognized need to encourage such construction (strongly enunciated by the Congress in the Housing and Urban Development Act of 1968), Congress is faced with a choice between two radically different forms of incentive: continued utilization of the Federal income tax laws or a direct Federal appropriation.

We submit that the past performance by the home building industry clearly demonstrates that provision of Federal income Tax Incentives is a more efficient and effective method of insuring the construction of necessary housing and should be retained. We fully agree with the statements made by the Chairman of this Committee to our members at a meeting held during our Annual Convention in Houston, Texas last January that it is clearly preferable as a general matter to provide Tax Incentives to encourage the private sector rather than to utilize Federal appropriations to accomplish the desired social purpose.

* * *

Congress recognized the necessity to provide incentives for the construction of rental housing when it enacted section 167(j) of the ode as part of the Tax Reform Act of 1969, which provided for the continued availability of then existing accelerated methods of depreciation only with respect to new residential rental property. The industry has since 1969 re-

sponded to these incentives by constructing a substantially increased number of rental housing units, both Federally assisted and conventional.

* * *

As indicated above, Congress enacted section 167(j) as part of the Tax Reform Act of 1969 to provide for the continued availability of all then existing accelerated methods of depreciation for new residential rental housing as an incentive to the construction of such housing. We believe that the purpose underlying the enactment of section 167(j) continues to be valid and retention of accelerated depreciation with respect to new residential rental housing is vital in order to provide the flow of investment funds necessary for the construction of such property. We also believe it is important to retain the provisions of section 167(j) permitting the depreciation of used residential rental property with a useful life of 20 years or more at a rate not in excess of 125 percent of straight line. This is necessary to assure in adequate resale market of such used rental property, thereby making it possible for such properties to be sold and the proceeds to be available to be reinvested in new residential rental property.

Moreover, we believe that the allowance for depreciation on residential rental property should continue to be determined on the basis of the full value of the property, including in the basis thereof the amount of mortgage indebtedness on such property. The determination of basis for depreciation purposes by

inclusion therein of the mortgage indebtedness on such property is consistent with the Supreme Court decision in *Crane v. U.S.* (331 U.S. 1 (1947)) and has been the long-standing judicial and administrative rule. Adoption of any proposal to exclude any portion of the value that is covered by a mortgage in determining the allowance for depreciation on residential rental property would substantially reduce the yield otherwise available from an investment in real estate and thereby significantly impeded the flow of necessary capital . . ." (emphasis added)

In discussion with the Committee, pertinent remarks were as follows (at p/ 3243):

"MR. CONABLE. Thank you. The fact that we have had a fairly successful three years should not in any way change our attitude toward the various preferences now implicit in the taxation of multiple housing, should it?

MR. MARTIN. In my judgment, in the past four years you wouldn't have had the rental housing construction, either for low-income families or otherwise, if we hadn't had the sources of equity from outside investors. And it hasn't been easy, in spite of what has been said earlier, to induce those people into these investments, because they are taking some real risk. There are several projects around the country in which they have lost their investment, and are continuing to lose. So this is a real risk situation. They have had some inducement to come in, in order to shelter income. But without that we wouldn't have had the production that we have had . . . [T]he biggest majority of residential in-

come property built within the last three years has had to have outside investors. Without these tax benefits, in my judgment, you just wouldn't have had them."

D. Statement of Phillip N. Brownstein, Washington Counsel, Council of Housing Producers, representing "a group of America's largest housing producers" (at pp. 3259-71)):

> "It was 3 ½ years ago today, September 26, 1969, that I appeared before the Senate Finance Committee to present the council's view on the tax reform legislation of 1969. Now 3 ½ years later, when all too many of our citizens are still living in substandard housing, and too many are paying a disproportionate share of their income for the housing they occupy.
>
> To compound the problem, subsidy programs have been suspended. The 1949 and 1968 housing commitments to our citizenry are being questioned and we undoubtedly will be lagging progressively behind each year in the achievement of the housing goals established in 1968.
>
> It was the 1968 Housing and Urban Development Act that quantified for the first time our Nation's housing needs and introduced the interest subsidy programs. The concept of the subsidy programs simply was to translate a demonstrated need into an effective demand by bringing the shelter cost within reach of those who otherwise have found it beyond their means.
>
> . . . (3261)

The programs are also pertinent to the tax matters under consideration by this committee since the 1968 housing act was predicated on the underlying assumption that the volume of production called for could not and ought not be achieved by government but would require the active and full participation of various elements of the private sector.

The Congress recognized that housing production is totally dependent upon the availability of capital. In the case of sales housing, it is primarily mortgage credit. But, of course, in rental housing, you have mortgage credit in addition to the need for long-term equity.

To help bridge this gap, the Congress, in the 1968 legislation, authorized the creating of the National Corporation for Housing Partnerships. That the corporation was clearly established with a tax-conscious investor in mind is evident from the statement contained in its initial prospectus which stated "it is anticipated that most of the financial benefits, if any, to the investors in the venture would be passed through to each partner of its share of the partnership losses in the early years arising principally from accelerated depreciation."

The National Corporation for Housing Partnerships has committed funds for some 22,000 units in 133 projects in 32 states, which is quite an impressive achievement. And certainly it couldn't have been accomplished without the incentives that were recognized to be available when the Congress chartered the partnership in 1968.

* * *

It is unlikely that housing, or for that matter, real estate in general, could compete in the capital market without the carefully chosen incentives Congress has written into our tax laws.

Notwithstanding the economic and social dividends of housing production, investment decisions are in the final analysis, most influenced by the net yield or return on invested capital. What is a sufficient yield varies with the particular investment. Because of the illiquidity of residential and other real estate, the necessity for long-term capital commitment and a host of external factors not generally associated with other areas of investment, investors in real estate have come to require a somewhat greater return than that available on other investments of comparable risk which have greater liquidity.

The ability to provide this return is inextricably linked to the favorable tax treatment afforded to an investor in residential real estate. Take away the favorable treatment, you reduce the net yield. You reduce the net yield, you lose your investor.

There is, of course, an alternative: increased cash flow. Now the quickest way to accomplish this is to raise the rents. A projection has been made to determine the effects of Tax Incentives on rentals. In a model which was a conventional unsubsidized project of 144 units with a total cost of 2.4 million, and $180,000

attributable to land, the projected rentals were $263 a month for each unit.

If depreciation is reduced to straight line, in order for the investor to obtain the same effective yield as he does from double declining depreciation, the rents would have to be increased by $34 a month to $297 (3263).

If, in addition, construction interest and fees are capitalized instead of taken as deductions, an additional rental increase of $37 would be necessary to produce a comparable yield on the investment.

The total of these two would represent a rent increase of 27 percent.

". . . Yet this course of action is precisely what many witnesses have urged upon this committee Limit depreciation to straight line; exclude the amount of any mortgage from the depreciable base; capitalize interest and real estate taxes during the construction period; permit deduction of interest only to the extent of gains on income; the list is seemingly endless, but by no means original.

This committee considered all of these proposals in 1969. The testimony of those who have appeared in support of these so-called reforms reveals no new convincing justification or rationale for their adoption, nor have satisfactory answers been supplied as to how we go about encouraging the investment of capital which is vital to the production of housing.

Once again, they have merely dismissed those incentives necessary to channel capital

into residential construction as inefficient, inequitable and uneconomical; a distortion of priorities and the tax system; a windfall for the wealthy.

But this characterization overlooks the underlying reasons for permitting incentives in the first place and how housing gets done absent such incentives. There were substantial revisions to the treatment given real estate in the tax reform act of 1969. The true impact of the 1969 act has been clouded somewhat by the relative availability of cheaper money in 1971 and 1972.

Furthermore, there really has not been an adequate period of time elapsed to furnish an accurate assessment of the 1969 legislation. I have principally discussed rental housing incentives. But I would like also to urge the continuation of the deduction for interest and taxes by homeowners which have provided incentives that largely contributed to making nearly two-thirds of our family's homeowners.

Economics are forecasting a substantial reduction in housing starts, particularly in rental units, in 1973. To aggravate further this condition by superimposing tax laws which discourage the investment of equity capital in housing could well create an imbalance in the economy of our Nation which will be borne by the segment of our population who can least afford it. That is the low- and moderate-income families that must rent its shelter." (emphasis added)

E. Statement of William B Dockser, President, Institutes for Government-Assisted Housing (at pp. 3329-3339), Accompanied by Bruce S. Lane, General Counsel:

"The institute is an association representing organizations involved in promoting and advancing the development, construction, ownership and management of Government assisted housing. Its members include developers, builders, investment bankers, mortgage bankers, housing management firms and syndicators of both publicly and privately offered tax sheltered programs for investment in Government assisted housing. The institute was formed in response to the need for an organization to act as spokesman for the emerging Government assisted housing industry. . .

The members of the institute seek to accomplish their objectives primarily through utilization of the National Housing Act, especially as it has been amended by the Housing and Urban Development Act of 1968, and through utilization of the Internal Revenue Code, especially as it has been amended by the Tax Reform Act of 1969. In other words, the institute and its members hold that tax sheltered programs insofar as they involve Government assisted housing are an instrument of national policy consciously and expressly designed by Congress to induce private industry to meet the urgent need for low and moderate-income housing.

By way of personal background, I served from 1969 until 1971 as an official of the Department of Housing and Urban Development,

where I held a series of positions directly related to the Federal housing programs. My last post was as Deputy Assistant Secretary for Housing production—Assistant FHA Commissioner. Presently, I am president of Kaufman and Broad Asset Management, Inc. Our firm has been involved in two public and several private offerings of tax sheltered real estate limited partnerships involving Government assisted housing. These partnerships, which we manage, presently own interests in 40 Government assisted housing projects involving approximately 4,800 dwelling units of low and moderate income housing.

Congress made a conscious decision in 1969 to use the Federal tax law in partnership with direct housing subsidies to induce private developers to produce more residential rental housing for all Americans and particularly for families of low and moderate income.

That decision, which was in keeping with the recommendation of the President's committee on urban housing (the Kaiser committee), was implemented by the enactment of provisions of the Tax Reform Act of 1969 favoring the construction of residential rental property, particularly low and moderate income housing, reducing the tax benefits favoring the construction of other types of real estate.

These incentives, working in concert with the housing subsidies provided in the 1968 and earlier acts, have between 1969 and 1972 dramatically increased the number of good quality housing units for low and moderate income families.

Over one-half of all the directly subsidized housing units created in the 36 years from 1935 to 1971 were produced in the 4 years of 1968 through 1971. From 1969 through 1971, directly subsidized units accounted for 18.6 percent of all new conventionally built housing in the United States, and 14.9 percent of all new housing, including mobile homes. In 1970 and 1971 combined, one out of every five new housing units produced was directly subsidized.

This clearly contributed to an all time housing production record of 2,581,000 units in 1971. Between 1968 and April 1972 directly subsidized housing units totaled 1,461,952. Of that sum, new construction of section 236 projects totaled 240,498 units or 16.5 percent of all subsidized units.

. . . (3332)

We favor retention of the provisions of present law. Use of double declining balance and sum of the years-digits depreciation is necessary to stimulate investment in this type of construction.

Estimates released on July 15, 1972, in a report of the Joint Economic Committee of Congress forecast the impact of removing accelerated depreciation from apartment building construction. Rents would rise 1 ½ percent and new development would slow down immediately.

A builder must realize a certain return on a housing project in order for it to be economically feasible. That return is made up

primarily of two factors: cash derived from rents, and the financial benefits derived from depreciation, either directly or by selling the depreciation to an investor.

In the case of section 236 housing, the maximum annual cash distribution is limited by HUD regulations to 6 percent of the HUD-determined equity investments in the project. Therefore, if the depreciation is reduced, there is little or no way to obtain a cash return; and such projects either will not be constructed or rents will have to be increased to permit a greater cash flow.

* * *

Until this provision (sec.167(k) of the code) was enacted, there was virtually no inner-city rehabilitation of low- and moderate-income housing. Since then, over 150,000 substandard housing units have either been or are being reclaimed and will provide decent inner-city housing for some of America's neediest families.

We believe that section 167(k) should be continued indefinitely beyond its December 31, 1974, expiration date and that it should be extended so that definition of families of low or moderate income is more flexible and will extend to more families in the $10,000-$15,000 income category.

* * *

[T]he Institute favors retention of the present law contained in section 1250(a)(1)(c). To

do otherwise would dramatically affect rents and greatly depress housing production.

As the Joint Economic Committee of the Congress has pointed out, if all of the capital gains from the sale of an apartment building were treated as ordinary income, such policy would raise rents by about 3 ½ percent, and the stock of multifamily housing would decline by 7 percent and new investment would continue at a 9-percent slower rate. Moreover, based on personal experience, I can assure the committee that the present recapture rule especially directed toward Government-assisted housing—that is, no recapture after 120 months—is one of the key elements that stimulates investor interest in this type of housing.

. . . .(3333)

We favor retention of section 1039, which was enacted in 1969 to promote tenant ownership of low- and moderate-income multifamily housing. Section 1039 is still so new that, to our knowledge, it has not been used by any project owner, and so it is too soon to evaluate it critically.

* * *

Builders of low- and moderate-income housing, like their counterparts in other areas of housing, enjoy current deduction of interest expenses and taxes during the period of construction. Any attempt to deny deductions of these valid costs would be a distortion of the cash and accrual methods of accounting which normally permit expenses to be deducted as

paid or incurred, and would violate the annual accounting concept.

* * *

As I indicated earlier, Congress has heretofore made a conscious decision to stimulate the production of low-and moderate-income housing through the tax laws. Such housing produces very little cash flow, however.

For example, section 236 projects are prohibited by HUD regulations from distributing cash in excess of 6 percent of the HUD determined equity investment in the project, to the extent that such cash is available after meeting debt services and all project expenses. Often there may be no such surplus cash.

Therefore, the main attraction to investors is the tax losses afforded primarily by the use of accelerated depreciation. This has usually been sold (syndicated) through the medium of a limited partnership wherein the sponsor-developer transfers the housing project to the partnership, becomes the general partner, and assumes responsibility for partnership interests which entitles them to most of the tax losses generated by the accelerated depreciation.

Despite the often-exaggerated claims of abuse in this area, the system has worked well. In fact, without it, very little low- and moderate-income housing would have been built in recent years, because under the existing section 236 program, this equity syndication technique is the principal way in which the

builder-developer can realize a profit. (emphasis added)

* * * (3334)

MR. ROSTENKOWSKI. Thank you, Mr. Dockser, for a very helpful statement.

* * *

MR. SCHNEEBELI: Mr. Dockser, it is quite evident that you know what you are talking about, both when you worked for the Government and since that time.

MR. DOCKSER: Thank you, sir.

MR. SCHNEEBELI: I am sure the facts and figures which you have outlined here will be of tremendous interest to our staff to analyze to see how they apply to the tax laws.

We appreciate your coming here. Thank you very much."

F. Statement of George W. DeFranceaux, Chairman, National housing Partnership, Accompanied by Sidney Friedberg, Executive Vice President (at pp. 3353-58):

"That National Housing Partnership is a private organization created by Congress under title IX of the Housing and Urban Development Act of 1968 to perform a public purpose, namely, to encourage the widest possible participation by private enterprise in the provision of housing for low and moderate income families."

The abilities of my company to carry out the task assigned to it by Congress—indeed, our very existence—is threatened by several of the

proposed amendments to the Internal Revenue Code.

* * *

2. There is a gap between the cost of building a housing development and the amount of money which low- and moderate-income families can afford to pay for those dwelling units, either as rent or purchase price.

3. To close this gap requires the joint efforts of Government and industry. Neither the public nor the private sector can do it alone.

4. There are only two possible incentives for the investment of Capital in the extremely risky business of providing shelter for low- and moderate-income families: (a) cash profits; and (b) Tax Incentives—chiefly losses generated by depreciation and other deductions which can be offset against [taxable] income derived from other sources.

5. Congress determined to provide the necessary motivation by means of Tax Incentives rather than cash profits. It did two things: (a) In the 1968 Housing Act, it set up the section 235 and section 236 programs to construct sale and rental housing respectively. The rental program limits cash distributions to 6 percent of equity investment and thus depends on existing tax provisions to provide the necessary investment incentive; (b) In the 1969 Tax Reform Act, Congress retained the most favorable methods of accelerated deprecia-

tion for newly constructed residential building, while reducing the tax advantages of other investments.

6. The use of Tax Incentives to achieve a public purpose has been criticized on philosophical [grounds] by respected tax scholars. The indisputable fact, however, is that the two-pronged congressional approach—limited cash distributions plus Tax Incentives—has worked. That is the prime reason why billions of dollars have been invested as equity risk capital in housing for low- and moderate-income families. Hundreds of thousands of such housing units have been built. Millions of low- and moderate income Americans are now living in decent homes instead of squalor of slums.

The national accounting firm of Touche Ross & Company recently completed, under contract with the Department of Housing and Urban Development a 'Study on Tax Considerations in Multifamily Housing Investments.'

This two-volume report emphasized the importance of Tax Incentives as a motivating factor in the commitment of private capital to the construction of housing.

Let me cite some figures.

In the 4 years following the enactment of the 1968 Housing Act—1969 through 1972—approximately 1 ½ million housing units were provided under Federal subsidy programs.

But the 10-year housing goal set by Congress in 1968 included 6 million subsidized units by 1978.

This means that we need 4 ½ million new units in the 6 years beginning with 1973 or an average of 750,000 per year.

Nevertheless, production has been falling father than rising. The annual [number] of federally subsidized new and rehabilitated housing units produced in the last 4 years has been: 1969, 226,000; 1970, 471,000; 1971, 472,000; 1972, 380,000 (estimated).

The picture becomes even bleaker when we realize that during the same 4-year period the Nation has lost an estimated 2 ½ million units from its housing stock by abandonment or demolition. Included in this loss were a disproportionately large number of units occupied by families at lower economic levels.

The cutoff of housing subsidies ordered by the administration on January 5 of this year will have disastrous consequences. Even if the subsidies are immediately restored in the same or a different form, this break in the pipeline will inevitably cause sharply reduced production of housing next year. Even before the January 5 freeze, only about 530,000 housing starts were estimated for the fiscal years 1973, 1974, and 1975, instead of the 2,250,000 needed to achieve the congressional goal. This is approximately 77 percent below the intended lever.

It is for this reason that I strongly urge the committee to recommend that Congress retain

the present tax structure which has successfully provided the incentive for private investment which, in turn, has maintained the production of low and moderate income housing at a satisfactory, although still inadequate, level during the past 4 years.

To be specific, I recommend that six provisions in the Internal Revenue Code be retained.

1. EXPENSES DURING CONSTRUCTION

* * *

Such expenses are deductible by a taxpayer who builds a factory for his own use, a home for his own occupancy, or a tennis court for his own enjoyment. That justification exists for denying those deductions to an owner of rental real estate?

2. INCLUSION OF NONRECOURSE MORTGAGE AMOUNT IN THE TAX BASIS.

No change should be made in the code and regulations which permit limited partners to include recourse mortgage on the property—that is, a mortgage on which the lender looks solely to the property for security and no partner is personally liable. Since a partner is not allowed to deduct losses in excess of his basis in the partnership, the nonrecourse mortgage rule permits him to receive the tax benefit of losses in excess of his cash investment. This leverage is particularly important in housing for low- and moderate-income families, where the Government-insured mortgage provides a higher debt-to-equity ratio—9 to 1—than in

conventionally financed projects—3 to 1 or less. It is vital to our operations that tax losses continue to flow through from the local partnership which builds the project to NHP's limited partners. It is these limited partners who supply the equity funds which make it possible for the local partnerships to construct the buildings, and it is these limited partners who are the intended beneficiaries of the housing incentives made available by the Internal Revenue Code.

The 270 limited partners of NHP invested over $42 million in response to Congress' appeal for private funds to be committed to the construction of decent homes for families of low-and moderate-income. They invested their money in reliance upon the Tax Incentives provided in the current Internal Revenue Code, including the pass-through of losses based on the inclusion of nonrecourse loans in the limited partners' basis. To change the rules now would be not only a breach of faith with the investors whose cooperation was specifically enlisted by Congress but also a breach of faith with the low-and moderate-income families who are still waiting for the decent homes promised them by Congress.

3. ACCELERATED DEPRECIATION

Congress, in the Tax Reform Act of 1969, reduced the accelerated depreciation available for non-residential real estate and also for residential property in the hands of someone other than the first user. At the same time, it retained the full double declining balance and sum-of-the-years-digits methods for new residential con-

struction, thus funneling equity funds where they were most needed: into housing for low-and moderate-income families. This policy was both wise and successful. In my opinion, it should not be changed.

Contrasted with the depreciation allowances provided for personal property, real estate depreciation is hardly accelerated; there is no 10-percent first-year bonus and no investment credit. The argument that economic depreciation may not parallel the tax allowances is no less true for personal property that for real estate. Actually, the decline in economic value of a building occupied by low- and moderate- [at p. 3356] income tenants through wear and tear is rapid. A substantial part of a real estate investment—the land itself—is not depreciable in any manner. Obsolescence of real state due to neighborhood changes, increased environmental controls, population shifts and the like, has never been more real.

4. REHABILITATION

The 5-year write-off for rehabilitation expenditures was a temporary experiment which will expire at the end of 1974 unless extended by affirmative congressional action. It is still too early, to assess the full impact of this program, but it has great promise and will help to stem the tide of deterioration and abandonment which has resulted in the loss of hundreds of thousands of dwellings each year. I recommend that Congress extend the rehabilitation program for another 5 years.

5. RECAPTURE

No part of a gain realized upon the sale of low-and moderate-income housing is subject to recapture at ordinary income rates if it has been held for 120 months, while the comparable holding period for conventional housing is 200 months. The additional incentive for investment in low-and moderate-income housing has bee successful in drawing capital into such projects. In my view, it should not be eliminated.

6. ROLLOVER

Section 1039, which added to the Internal Revenue Code in [1969], provides that the gain realized upon a sale to tenants of housing constructed under Federal subsidy programs can be deferred if the proceeds of sale are reinvested in a similar project within 1 year. To date, there have been no sales of subsidized housing projects to tenant cooperatives or condominiums, because the projects which have come on stream during the past 4 years are still too new for conversion to tenant ownership.

We at the National Housing Partnership believe that home ownership is a worthy goal, and we would welcome the sale of our projects to the tenants as soon as they are ready and willing to assume the responsibilities of ownership and management. Therefore, we urge Congress to retain the rollover privilege granted in section 1039, which is still untried and untested. The National Housing Partnership was created pursuant to title IX of the

Housing and Urban Development Act of 1968. The opening paragraph of this legislation states:

> 'Section 901. The Congress finds that the volume of housing being produced for families and individuals of low or moderate income must be increased to meet the national goal of a decent home and a suitable living environment for every American family, and declares that it is the policy of the United States to encourage the widest possible participation by private enterprise in the provision of housing for low or moderate income families.'"

The Congress has therefore determined that one or more private organizations should be created to encourage maximum participation by private investors in programs and projects to provide low and moderate income housing." (emphasis added)

G. Statement of A. Carleton Dukess, Continental Wingate Co., New York, N.Y., and National Housing Rehabilitation Association. (at pp. 3406-21):

> "[W]e are the nation's largest and oldest company in the development, construction and operation of subsidized rehabilitated housing in the inner city.
>
> * * *
>
> I think the constitution [sic] of section 167(k) or a meaningful substitute for it has become a critical consideration for this committee as a result of the testimony of Secretary Lynn be-

fore the Housing Subcommittee of the Banking and Currency Committee last week. Secretary Lynn of the Department of Housing and Urban Development stated that among the programs which would be exempted from the subsidy housing moratorium would be Project Rehab. Secretary Lynn affirmed that as one of the continuing programs[,] the Department of Housing and Urban Development intends to provide funding for Rehab subject to authorization and appropriation by the Congress.

I am here to state that in our experience funding of Project Rehab and attempting to continue this program in the absence of 167(k) or an acceptable alternative will be an exercise in frustration because it cannot be done. Rehab in housing, which could be called restoration or preservation of deteriorating structures, I think, is a very good thing, and I would like to take a moment to state some of the very basic reasons why. It stabilizes and upgrades existing neighborhoods, thus taking advantage of the existing streets, the existing utilities, schools, religious, recreational, commercial and transit facilities. . . ." (3408) (emphasis added)

The submitted statement of Mr. Dukess stated (at p. 3411):

> "First—The profit derived from the investments of those seeking tax shelter is sufficient to entice the private sector into this new industry. The NHRA could not have recruited any members prior to 1969—there weren't for companies attempting rehab—now some, such as mine, are publicly held and making fair return on their capital.

Continued profits will continue to attract others into the field.

Second—One of the costs involved in creating the new approach to landlord-tenant relations is providing on-site staff prior to occupancy of the buildings. Without occupancy there is neither rent nor management fees. Management fees don't even reach a break-even point until 300 or so apartments are occupied. Here again, the use of the money received from the investor seeking tax shelter which is usually received at the start of construction, allows the developer to defray these costs and not have to 'shoestring' an essential element of the operation. There is no other presently available source of these funds.

Moreover, and of incalculable importance, is the fact that the developer, in order to create this new relationship must establish his credibility in the community. Most communities in which rehab is appropriate lack faith in government and private enterprise. By use of 167(k) developers can tell the community that (a) they are profit motivated and (b) their profit does not come from the community.

Mr. Chairman, this one factor has been responsible for reaching more realistic accords with community organizations that any other. Unlike the other housing subsidy programs, there is no contribution to the developer coming from rents. Thus, the developer is responsible for bringing something to a community with which he must work and

he need not ask that community to contribute to his profits." (emphasis added)

V. Tax Revision Issues—1976

A. Staff of the Joint Committee on Internal Revenue Taxation, Tax Revision Issues—1976 (H.R. 10612). Tax Shelter Investments (Comm. Print 1976).

The study states (at pp. 25-32):

"3. REAL ESTATE

General

The real estate industry is a capital intensive industry

To provide this capital, a number of investment vehicles have been utilized which allow investors to pool their financial resources. This pooling of investment is commonly referred to as "real estate syndication" and may be set up as a joint venture, a partnership, a real estate investment trust, or a corporation.

* * *

A real estate investment decision generally involves an evaluation of the potential risks and a comparison of those risks with the overall rate of return, including the potential cash flow, the potential for appreciation, and the potential tax benefits. The various provisions that provide tax benefits for real estate include the deduction for accelerated depreciation, the deduction for interest and taxes during the construction period, the deduction for prepaid interest, the rules of partnership taxation (including the determination of a partner's basis,

especially the treatment of nonrecourse loans, and the allocation of income and losses among the partners), and capital gains treatment upon the sale of the property.

In general, a real estate tax shelter is an investment in which a significant portion of the investor's return is derived from the realization of tax savings on other income as well as the receipt of tax-free cash flow from the investment itself.

* * *

These deductions (construction period costs and accelerated depreciation) combine to generate losses which can be used to offset income from other sources, such as salary and dividends. In effect, taxpayer is allowed to defer or postpone the payment of tax on current income, either by offsetting current income with loss deductions attributable to real estate or by receiving a tax-free cash flow from the real estate project, or both.

The entity most commonly used to create real estate tax shelters and produce the maximum tax benefits for an individual investor is the limited partnership. Typically, a real estate venture is syndicated as a limited partnership with the builder-entrepreneur as the general partner and the investors as limited partners. Unlike a corporation, the partnership itself is not subject to tax, but serves as a conduit through which the tax consequences of a particular project are passed to the individual partners. Thus, to the extent that the partnership incurs losses during a particular

taxable year, these losses are allocated to and become the individual losses of the various partners.

* * *

In addition to generating tax losses, these deductions may not subsequently be subject to recapture, thus resulting in the conversion of ordinary income into capital gain.

* * *

In addition, . . . special amortization rules are provided for expenditures to rehabilitate low income rental housing (sec. 167(k) of the code). Low income rental housing includes buildings or other structures that are used to provide living accommodations for families and individuals of low or moderate income. An individual or family is considered to be of low or moderate only if their adjusted income does not exceed 90 percent of the income limits described by the Secretary of HUD for occupants of projects financed with certain mortgages insured by the Federal Government. The level of eligible income varies according to geographical area.

Under the special amortization rules for this low or moderate income property, taxpayers can elect to compute depreciation on certain rehabilitation expenditures under the straight-line method over a period of 60 months if the additions or improvements have a useful life of 5 years or more. Only the aggregate rehabilitation expenditures as to any housing which do not exceed $15,000 per dwelling unit qualify for the 60-month depreciation. In addition, for

the 60-month depreciation to be available, the sum of the rehabilitation expenditures for two consecutive taxable years—including the taxable year—must exceed $3,000 per dwelling unit.

* * *

In addition, in the case of certain Federal, State, and locally assisted housing projects constructed, reconstructed, or acquired before January 1, 1976, such as the FHA 231(d)(3) and the FHA 236 programs, the pre-1976 recapture rules on property is constructed, reconstructed or acquired after December 31, 1974, the regular post-1969 rules previously discussed above with respect to residential property will apply (i.e., a one percent reduction per month after 100 months).

* * *

Because of the present tax situation, when an investment is solicited in a real estate venture, it is argued that it has become common practice to promise a prospective investor substantial tax losses which can be used to decrease the tax on his income from other sources.

* * *

Many argue that the provisions of present law providing incentives are essential to attract investment in an industry already suffering from a shortage of capital. Without these incentives, they urge, the capital shortage problem will be severely aggravated." (emphasis added)

B. In 1976, the co-called "limitation on accounting losses" ("LAL") was included in the bill reported by the House which later became the Tax Reform Act of 1976 (H.R. 10612). LAL was designed to limit the deductibility of losses from tax shelters. However, the House bill had a grandfather clause to bar a retroactive application of LAL to existing low and moderate income housing projects. In regard to LAL, the Congressional study stated (at p. 117):

> "The House bill imposes a limitation, commonly referred to as LAL (limitation on artificial losses), on the extent to which losses arising from accelerated deductions with respect to certain activities can be used to offset a taxpayer's other income. Under this limitation, specified accelerated deductions are not allowed in the taxable year in which such deductions are paid or incurred to the extent they exceed a taxpayer's net income from the activity. These deductions are to be deferred until either the taxpayer has income from that activity in a future taxable year or until he disposes of the property to which the accelerated activities, the limitation is not to apply to true economic losses which are to continue to be deducted currently. The following is a brief description of the application of the LAL provision with respect to each of the activities to which it applies.
>
> 1. Real Estate
>
> In the case of real estate, all real property would be fully consolidated for purposes of LAL. The accelerated deductions attributable to real property would be deferred in a "de-

ferred deduction account" to a later year to the extent that the deductions exceed the taxpayer's related income from real property. Net related income is gross income from real property less the "ordinary deductions" attributable to real property (deductions other than the accelerated deductions). The limitation would not apply to true economic losses which would continue to be deductible currently.

The accelerated deductions which would be limited as indicated above are the deductions for interest and taxes during the construction period, and accelerated depreciation in excess of straight line depreciation.

In general, LAL would apply to commercial and residential property where the construction begins after December 31, 1975. However, LAL would not apply to residential real property if (a) before January 31, 1977, the taxpayer has acquired the site (or has a binding option to acquire the site) and there is a firm commitment for the permanent financing of the property and if (b) construction begins before January 1, 1978. In addition, LAL would not apply to governmentally subsidized low-income housing if (a) before January 1, 1979, the taxpayer acquires a subsidy commitment under section 8 of the United States Housing Act of 1937 (or a comparable State or local subsidy commitment) and if (b) construction begins before January 1, 1981."

The Senate did not accept LAL and it was not included in the Tax Reform Act of 1976.

VI. Hearing on Tax Abuse in Federal Housing Programs 1979

Potential for Abuse of Tax Code in Federal Housing Programs: Hearing before a Subcommittee (Government Operations Subcommittee on Manpower and Housing) of the Committee on Government Operations, House of Representatives, 96th Cong., 1st Sess. (1979).

A. Opening Statement of Chairperson, Representative Cardiss Collins (at p. 1):

> "There is another source of assistance for limited dividend projects that can be used to bring pressure for better management or even to increase the money available to the project—limited partners who put up the down payment to enjoy a tax shelter.
>
> The tax shelter is principally attractive to the 1 percent of taxpayers in the 50 percent and higher tax bracket. It permits them, through paper losses attributable to accelerated depreciation, to deduct as losses more than their investment.
>
> However, if a project is foreclosed within a stated period, the taxes deferred through accelerated depreciation must be paid back. HUD had always pointed out that investors' fear of tax benefit recapture can act as an incentive for the partnership to keep the project afloat. Indeed, in some cases it has worked this way." (emphasis added)

B. Statement of Singleton B. Wolfe, Assistant Commissioner, Compliance, IRS (p. 10):

"To encourage the development and maintenance of low-income housing, Congress has, over the years, added several provisions to the Internal Revenue Code. Those in section 167 are intended to encourage the construction and rehabilitation of low-income housing, whereas the section 1250 provisions are intended to discourage the early disposition of such properties.

Section 167(k) of the Internal Revenue Code permits taxpayers to make a depreciation election for certain expenditures made in the rehabilitation of low-income rental housing.

Provided the property in question has a useful life of 5 years or more, taxpayers owning such units may elect to depreciate eligible rehabilitation expenditures of as much as $20,000 per dwelling unit over a 5-year useful life.

To qualify as low-income housing, the dwelling unit musts be held for occupancy by families and individuals whose income does not exceed limits determined by the Secretary of the Treasury or his delegate, in a manner consistent with the limits established for leased housing under section 8 of the United States Housing Act of 1937.

In addition to the 5-year depreciation of eligible rehabilitation expenditures provided in section 167(k), owners of low-income housing units may use another method of accelerated depreciation permitted under section 167(j).

Each of these provisions has in common allowing the owner taxpayer to claim deprecia-

tion deductions more quickly than would be permitted under the straight line method of depreciation.

* * *

Section 1250 relaxes the general rule requiring complete recapture of accelerated depreciation in the case of the four types of low-income housing specified in section 1250(a)(1)(B).

With respect to these types of low-income housing, all depreciation is recaptured if the property is not held for more that 12 months. If the property is held for more than 12 months, the only depreciation recaptured is all or a portion of the depreciation in excess of the depreciation deductions that would have resulted had straight line depreciation been claimed over the actual useful life of the property.

Again, the gain on sale due to depreciation is treated as ordinary income rather than capital gain to the extent of the depreciation recaptured. The portion of the depreciation recaptured varies depending on the length of time the property is held.

In general, if the property is held 100 months or less, the entire excess depreciation is recaptured, while if the property is held for more than 100 months, the excess depreciation recaptured is reduced 1 percent for each month in excess of 100 months the property is held. Accordingly, after 200 months—16 2/3 years,—no recapture would occur.

As you are aware, Madam Chairwoman, syndicated investment arrangements—and particularly tax shelters—frequently are conducted in partnership form. Limited partnerships are particularly common in real estate, and we are informed by our colleagues at HUD that this is equally true in the case of low-income rental housing.

Under our Federal income tax laws, the partnership itself is not a taxable entity. Rather, it acts as a conduit for its partners.

The partnership's overall income or loss, as well as each item of income, gain, loss, deduction and credit, is computed on a partnership information return and distributive shares of those items are allocated to each partner. The partners are then required to their distributive shares of these items on their individual income tax returns.

* * *

[T]he majority of low-income subsidized projects are owned by limited partnerships . . ." (emphasis added)

At pp. 21-56, the written statement of Mr. Wolfe was submitted, as follows (p. 22):

"To encourage the development and maintenance of low-income housing, congress has over the years added several provisions to the internal revenue code. Those in section 167 are intended to encourage the construction and rehabilitation of low-income housing, whereas section 1250 provisions are intended to discourage the early disposition of such properties.

Section 167(k) of the internal revenue code permits taxpayers to make a depreciation election for certain expenditures made in the rehabilitation of low-income rental housing. Provided the property in question had a useful life of five years or more, taxpayers owning such units may elect to depreciate eligible rehabilitation expenditures of as much as $20,000 per dwelling unit over a five year useful life. To qualify as low-income housing, the dwelling unit must be held for occupancy by families and individuals whose income does not exceed limits determined by the secretary of the treasury (or his delegate) in a manner consistent with the limits established for leased housing under section 8 of the United States housing act of 1937.

In addition to the five year depreciation of eligible rehabilitation expenditures provided in section 167(k). Owners of low-income housing units may use another method of accelerated depreciation permitted under 167(j).

Each of these provisions has in common allowing the owner/taxpayer to claim depreciation deductions more quickly than would be permitted under the straight line method of depreciation. To illustrate, assume the following facts:

A taxpayer spends $70,000 to acquire a rental building with four dwelling units and makes rehabilitation expenditures of $10,000 with respect to each of the four units, bringing the total cost of the building to $110,000. The building has an estimated useful life of 25 years and a salvage value of $10,000.

If the taxpayer claimed straight line depreciation with respect to the rental building, the taxpayer would be entitled to claim a depreciation deduction during each of the 25 years of the building's life equal to $4,000: the $100,000 decrease in the value of the building ($110,000 cost less $10,000 salvage value) would be claimed ratably over the building's useful life.

If the dwelling units in question qualified under section 167(k), however, and the taxpayer elected to claim depreciation deductions under that provision with respect to rehabilitation expenses and the remainder of the building's cost, the taxpayer could claim depreciation deductions of $10,400 during each of the first five years of the building's useful life and of $2,400 during each of the remaining 20 years as follows:

VIII. Each of the first 5 years: $10,400

1/5 of $40,000 rehabilitation expenses	$8,000
Rehabilitation expenses less	$10,000
(salvage value)	$2,400

IX. Each of the next 20 years: $2,400

1/25 of $60,000

Under section 1250 of the code, gain on the sale or the disposition, including foreclosure, of depreciable real property is generally recaptured and taxed as ordinary income rather than capital gain to the extent that the gain represents depreciation allowed in excess of the amount that would have been allowable under the straight line method. Circumstances that give rise to recapture include sales, including foreclosures, and

with certain exceptions," exchanges and involuntary conversions section 1250 relaxes the general rule requiring complete recapture of accelerated depreciation in the case of the four types of low-income housing specified section 1250(a)(1)(b)."

C. Statement of Marilyn Melkonian, Deputy Assistant Secretary for Multifamily Housing, HUD, p. 64:

"However, in addition to that, limited partnerships also make other contributions. Because of the incentive for tax advantages in these projects, they are willing to take on startup costs that would otherwise not be paid for. They are willing to create operating reserves for these projects that would not otherwise come forward, particularly in a two-tier situation that Mr. Luman was referring to before.

They are also willing to come forward at later times when projects are in trouble and make additional contributions.

You have to keep in mind that the principal incentive for investment in these projects was the tax advantage. Congress knew that subsidized housing would not attract investment for the traditional reasons; namely the expectation that the property would appreciate in value, or the expectation that there would be considerable cash flow from the project. So the principal reason for making an investment in these projects was the tax advantage. And without that advantage, it is certainly clear to me in my experience, that we would not have built in

many parts of this country, including places, mostly in the inner city, or places in central cities, like New York, in Brooklyn, in the Bronx, Harlem, in Chicago certainly in the Lawndale area, places like that would never have been able to attract private—

MRS. COLLINS: The Chicago Lawndale area is not attracting subsidized housing right now.

MS. MELKONIAN: That is correct. But we do have, as you know, a major project underway which will take advantage of the benefits that are provided under the tax laws to attract significant investment into an area that would otherwise not normally attract that investment.

MRS. SNOWE: So you are very dependent on these kinds of investors based on limited partnership.

MS. MELKONIAN: Yes, very dependent." (emphasis added)

VII. Hearings on Rental Housing Legislation—1989

Hearing before the Subcommittee on Housing and Urban Affairs, U.S. Senate, Administration Views on Rental Housing Legislation, 96th Cong., 2nd Sess. (1980).

A. Secretary Moon Landrieu, Department of HUD:

". . . there's been a negative trend in rental housing production and that trend is forever worsening. I can foresee that eventually there will be no conventional building of rental units of all and that the only multifamily units that

will be build will be those that are either insured, subsidized, or assisted through some other Federal incentive for the industry.

Now, I think it's sad that the private sector is moving out of rental housing production altogether, and I know of no one single thing that we can do to reverse that trend . . .

Please be assured that these subsidies exist whether they're a direct subsidy to the tenant or whether they are tax subsidies to the developer. They are nevertheless a subsidy.

Apparently the tax subsidies which currently exist in the rental market are not sufficient . . . (at p. 24) The element of risk is so great that the private sector, unless it has assurance from the Government, is not going to entertain that risk.

Now, sometimes in this country, we have forgotten precisely what the term 'profit' means. Profit does not reflect a wage paid for labor. It represents a return on risk, and that suggests the possibility of loss as well as gain. And to the extent that the risk exceeds that potential for gain, then you obviously have less risk taken.

The only place that I know that's succeeding against that general theory is Las Vegas. But in terms of the real estate market, its fairly sensitive to the risks that are involved.

HOUSING FOR THE POOR

So, if the Federal system wants housing for the poor, then the Federal Government obviously is going to have to underwrite that risk.

And we induce people into that field who would otherwise not be there, because we're prepared to underwrite that risk.

If anyone is in the building business today, they have absolutely no incentive, except that offered by the Government to build housing for the poor. That housing is difficult to manage. There is absolutely no control over the costs of operation and maintenance. There's no cost control over energy. If you could get the long-term financing, you're obviously looking at the prospect of having to refinance without insurance.

So, why would one want to be in that market? (emphasis added)

Now you get operators, provided they're subsidized. We went too far in my judgment, in the mass transit business, because what we effectively did was to drive out of the business entirely for the private sector. It would have been better for us to have maintained the private sector with a subsidy, rather than have the Government begging to operate the transit business.

Right now where we are in the housing business is that we are providing subsidies to the private sector." (emphasis added)

This statement by the Secretary of HUD to Congress is a strong basis for a conclusion that the taking away of Tax Incentives from existing low and moderate income housing projects represents a confiscation of the projects.

VIII. Economic Recovery Tax Act of 1981

In 1980 and 1982, hearings were held on the legislation that eventually was enacted as the Economic Recovery Tax Act of 1981.

The proposals of the President and various Congressmen that led to this Act provided for substantially more rapid depreciation on personal property, but would have eliminated accelerated depreciation with regard to real property.

Witnesses brought to the attention of Congress that any such legislation would cut off capital investment in low and moderate income housing, since (1) such housing had no economic return and involved services and risks far beyond those involved in conventional real estate development and management, and (2) the proposals would reduce the Tax Incentives for such investment both in absolute terms and in relation to alternative investments (e.g., in equipment leasing).

In response, Congress permitted 200% accelerated depreciation to remain in effect for low and moderate income housing, while at the same time providing for straight-line depreciation or less rapid accelerated depreciation in regard to other types of real estate.

Excerpts from the testimony include the following:

A. House Ways and Means Committee, Hearing on Advisability of a Tax Reduction in 1980 Effective for 1981, 96th Cong. 2d Sess. (1980).

1. Statement of Bruce S. Lane, Counsel, Coalition for Low and Moderate Income Housing:

"We welcome efforts such as yours, Mr. Chairman, in the Tax Restructuring Act of 1980 to develop shorter, audit-proof lives for housing and other real estate. This bill falls short of achieving this goal in two respects, however, first, because of the restrictions on the rate of return, rental fees which may be charged and resale opportunities, there must be some compensating Tax Incentives for the construction of this type of housing. Without some incentives, investors will prefer the less restrictive and more economically profitable investments in market rate housing, and no government-assisted housing will be built. Most experts in the real estate industry agree that there must be differential built into your depreciation schedule, such as a five-year shorter useful life, for government-assisted housing." (emphasis added)

B. House Ways and Means Committee, Hearing on Tax Aspects of the President's Economic Program, 97th Cong. 1st Sess (1981)

1. Statement of William K. Langelier, Chairman, Coalition for Low and Moderate Income Housing:

"Low-income housing is often a risky investment, either because of its location or its tenant mix or both. And it is subject to a considerable amount of governmental regulation and red tape. All residential housing is exposed to the potential of rent control.

Given that scenario, Mr. Chairman, as an investor where would you put your money, in a hotel, an office building or a shopping center,

or in a low income or other residential housing project?

* * *

With the reduction in individual income tax rates and the highly favorable treatment of capital gains, investors will more and more look for investments that produce significant cash flow and enjoy a high probability of significant residual value. Properties which reflect these characteristics are primarily office buildings, shopping centers and hotels.

Low income housing is severely restricted in most instances as to the rate of cash return to investors, either by HUD or by a state agency, and also is usually prohibited from resale for at least 20 years by HUD or a state agency. There are, of course, no restrictions on hotels, office buildings, or shopping centers with respect to either cash distributions or the timing of a resale.

Also, unless Congress acts this year, the advantage to low income housing of Section 189 of the Code, permitting current deduction of construction period interest and taxes, is due to expire as of December 31, 1981." (emphasis added)

2. Statement of Thomas M. Tweel, on behalf of the National Housing Partnership:

"In order to raise the capital necessary to finance the production of low income housing, NHP sells a portion of the equity interest in its projects to private investors, in the form of limited partnership interests. Private capital

has been attracted to this endeavor primarily because of the unique tax benefits conferred by previous Congresses. In the areas of accelerated depreciation schedules, the phase-out of depreciation recapture and the ability to deduct construction period interest and taxes, Congress has secured a favored tax position for investors in low income housing.

That favored status must be maintained because government assisted rental properties are subject to specific legal restrictions as to cash earnings, and resale may be prohibited for 20 years or more. These properties may be perceived to have much more limited potential for appreciation than other real estate investments.

Although the President's Economic Recovery Program appears to recognize the need to maintain a special status for low income housing, the Program does not go far enough to provide adequate incentives for low income housing. Under the Program, low income housing is allowed an 18 year depreciable life, with a 3 year phase-in to 15 years. Non-subsidized housing would be allowed in 18 year depreciable life, with no phase-in. Commercial facilities, however, such as office buildings, shopping centers, and hotels would be eligible immediately for 15 year depreciation. During the 3 year phase-in period, low income housing would be at such a competitive disadvantage that it might disappear. Furthermore, because all property would be restricted to the straight line method, the advantage previously granted to investors in low income property through

accelerated depreciation and the phase-out of recapture would no longer exist.

* * *

The President's Program would make significant reductions in the rates of investment recovery during the critical first five years on investments in low income property. (Investment recovery for this period it highly significant in making an investment decision.) In addition, the President's Program would cause investments in low income housing to be substantially less attractive when compared with competing real estate investments. Both of these comparisons suggest that there will be a substantial diversion of funds from low income housing. (See attached rate of return and investment recovery comparisons.)

One competing investment with substantial new advantages is non-residential real estate. The proposed rules for non-residential real estate produce a dramatic improvement in the relative rate of return over the treatment available under current law. The tax benefits that would be available to office and commercial buildings would become fully comparable with subsidized housing. Taking into account the greater potential for resale, cash flow, or refinancing of non-residential real estate, it becomes evident that low income housing would be at a severe disadvantage in its ability to attract private investment dollars.

Similarly, although the President's proposal would continue to provide somewhat greater tax benefits for low income housing than for

market rate residential property, the differential is slight. Furthermore, when even a modest rate of appreciation is applied to the investment in market rate housing, the differential is completely negated." (emphasis added)

C. Senate Finance Committee, Hearing on Tax Reduction Proposals, 97th Cong. 1st Sess. (1981).

1. Testimony of Stephen Smith, on behalf of National Leased Housing Association:

"Under President Reagan's proposal, low- and moderate-income housing would be entitled to an 18-year, straight line depreciation rate, phasing down to 15 years, by 1983.

In the meantime, industrial and commercial real estate would be entitled to a 15-year, straight line rate of depreciation immediately.

But even after the phase in period, placing section 8 and other low-income housing on a par for depreciation purposes, with industrial and commercial real estate, actually results in putting it at a great disadvantage since such housing is subject to many restriction such as Government limitations on the rate of cash return to investors and on the right to resell.

In some cases, federally imposed rent controls may also be applicable.

There are, of course, no such restrictions on hotels, office buildings, shopping centers.

In addition, section 8 housing is often risky, either because of its location or its tenant mix, or both, a problem not usually inherent in other types of real estate.

Don't forget the Government red tape that is involved in section 8 housing production.

* * *

MR. SMITH: I would certainly agree with that, Senator, that it is really the heart of our proposal that subsidized housing in particular, must have a differential treatment under the tax code, as it does today, in order to attract equity capital.

If other forms of real estate, office buildings, shopping centers and so forth are at party with housing, the equity capital will simply not go into housing, as was discussed by the earlier panel. They are a greater risk, there are greater problems associated with housing that are just not inherent in these other types of real estate.

I think it is also important to note that low- and moderate-income housing has even further disadvantages or disincentives to investment with respect to even other types of housing that also have to be recognized in the tax code as they are today, under section 189 and under the recapture provisions of the code." (emphasis added)

2. Statement of Mr. Gregg Smith, Council of State Housing Agencies:

"The program provides many disincentives for investing in housing, namely:

Investors will continue to look for investments which produce significant cash flow and under this proposal they will invest primarily in office buildings, hotels and shopping malls.

Low income housing is restricted as to the rate of cash return to investors and Section 8 housing is prohibited from resale for at least 20 years. There are no such restrictions on hotels, shopping malls or office buildings.

Low income housing is a riskier investment due to both the amount of government red tape and regulation and the potential for rent control.

According to a Joint Economic Committee report, sophisticated investors view the multi-family structure as a relatively risky non-inflation proof investment.

According to the National Association of Realtors evaluation of the President's proposal, 'a building made out of the same materials and having the same economic life could be at least fifteen percent less costly for the commercial and industrial user than for individuals providing rental housing.' This means an opportunity for greater profit." (emphasis added)

IX. 1985 Hearings on Tax Reform on Small Business

Impact of Tax Reform on Small Businesses: Hearings before the Subcommittee on Tax, Access to Equity, Capital & Business Opportunities, Committee on Small Business, House of Representatives, 99th Cong., 1st Sess. (1985).

A. Opening Statement of Chairman Luken: (p. 2)

". . . By lengthening depreciation schedules for real property, denying capital gains treatment for depreciable property, and limiting in-

terest deductions for many investors, this program [the Treasury's 1985 Tax Proposa[s] could bring a virtual halt to apartment construction and an increase in rents that could dwarf any tax benefit renters might receive from the bill." (emphasis added)

EXHIBIT K

EXCERPTS FROM NATIONAL HOUSING PARTNERSHIP REPORTS

The following are excerpts from reports of the National Corporation for Housing Partnerships and the National Housing Partnership (collectively "NHP") founded by the Housing and Urban Development Act of 1968.

First Annual Report (1968-1970) National Corp. For Housing Partnerships, 81st Congress, 2d Sess., Annual Report (Comm. Print 1970)).

In the First Annual Report the Chairman, Senator John Sparkman, stated:

> "[This] report outlines how the Corporation will fulfill the congressional mandate of increasing the involvement of private businesses in the production at low and moderate income housing . . . A total of $42,050,000 in private capital was raised from 268 private companies, labor organizations and banking institutions.
>
> I have great faith in the private enterprise system and I look forward to the success of this resources and a ingenuity of private industry are joined together to meet a specific objective."

This report reiterated the need for incentives for the development of low and moderate income housing as follows (pp. 1-2):

> "In Section 901 of the 1968 Housing Act, Congress reaffirmed 'the national goal of a decent home and a suitable living environment for every American family.' Congress found the volume of housing being produced for families and individuals of low - or moderate - income must be in-

creased to meet this national objective, and stated that one or more new entities should be created to encourage maximum participation by private organizations in programs and projects to produce low - and moderate - income housing. This determination reflected congressional recognition that new methods for involving large corporate, labor, and financial institutions in housing programs for low - and moderate - income families had to be found.

To meet the need, the [President's Committee on Urban Housing] recommended large-scale, prompt and concerted efforts by Federal and State, and local governments and the fullest possible participation of private enterprise in innovative programs. The committee believed that existing Tax Incentives could be used to encourage greater involvement of business in such programs. The methods, practices, incentives and economies normally associated with the production of publicly assisted housing."

The report went on to describe the Tax Incentives as follows (pp. 2, 5 8):

"The limited partnership form of business organization was selected to make available to corporate investors the tax benefits customarily associated with investment in housing. The Corporation was designated as the Partnership's sole general partner. The issuance of the prospectus for the public offering was necessarily delayed by congressional consideration of the proposed Tax Reform Act of 1969. There was a possibility that amendments to the Internal Revenue Code of 1954, particularly to sections dealing with depreciation, would reduce or jeopardize the tax bene-

fits available to investors in real estate, increasing the already high risks of investment in publicly assisted housing. These possibilities did not materialize. Instead, the Tax Reform Act of 1969 reaffirmed the favorable tax treatment accorded investments in residential housing and created new Tax Incentives for those who invest in low and moderate income housing.

Under best conditions now prevailing, housing cannot be produced at a market price which low - and moderate- income families can afford without significant public financial support. As a result, State and local publicity assisted housing constructions and rehabilitation programs. The Partnership, as a local limited partner, will receive its pro rata share of the tax benefits and cash distributions arising from investment in local limited partnership. Each partner in the Partnership will in return receive its pro rata share of the benefits accruing to the Partnership."

1971

In the 1971 Annual Report, the continuing commitment of the government to encourage the development of housing was reflected in the following excerpt (p. 3):

"In January of 1976, the President of the United States issued a statement on housing, and pledged: ". . . that this Administration will take every possible step to solve this most serious housing problem consistent with the overriding need to contain inflation. The housing of our people is and must be a top national priority."

This report described the working of the Tax Incentives - and the necessity for the incentives - as follows (pp. 5, 12):

> "Significantly, when the general income tax structure was last revised, the Congress retained tax benefit provisions specifically designed to attract risk investment to stimulate and support residential construction for low and moderate income families.
>
> In fact, the 1968 Congressional Act which founded NCHP states, '. . . Sec. 902(a). There is hereby authorized to be created a private corporation for profit . . .'
>
> As you know, the annual return to NCHP investors does not come in the form of dividends derived from earnings per share.
>
> Instead this return comes from the use of the Partnership's annual tax losses which are generated primarily from:
>
> —deductible construction costs and accelerated depreciation of the local housing project, and
>
> —net operating expenses of NCHP.
>
> Such tax losses are passed on to our investors and can be used by them to offset taxable income from other sources.
>
> It is the goal of NCHP that the benefits arising from the use of these tax losses will produce an ultimate yield to investors that compares favorably with the return on equity capital realized by most industrial firms.

NCHP took the leadership in urging the Congress in effect the "roll-over" failure in the Tax Reform Act of 1969.

By this action, financial sponsors like NCHP can offer ownership of their home units to residents, under condominium or cooperative approaches and without tax consequences, so long as the funds are reinvested in other approved housing projects within a year.

Ownership is a U.S. hallmark, and NCHP hopes that many of its projects will move into resident ownership.

Incentive and profit opportunities are necessary to attract risk capital and qualified development team participation in the planning, building and management of assisted housing."

1972

The 1972 Annual Report explained the relationship between the goal of more low and moderate income housing and the means of Tax Incentives as follows: (pp. 4.6):

"NHP is a private organization for profit. Its prime mission, as spelled out by the Congress, is 'to encourage the widest possible participation by private enterprise in the provision of housing for low or moderate income families.'

Our success must be measured in two ways:

1. The number of low and moderate income families who would not have been able to enjoy decent housing in a suitable living environment if you, as our partners, had not made the necessary funds available.

2. A monetary return principally in the form of tax losses which can be used to offset your taxable income from other sources.

NHP continues its emphasis on rental projects which provide the best housing for the market we serve and the maximum tax benefits to our national partners who supplied our capital."

1973

The 1973 Report provides a clear statement of how the NHP—founded by an Act of Congress—raised investor funds for low and moderate income housing based on the Tax Incentives. It states (pp. 2-6):

"We have made significant progress during 1973 in our commitment to provide housing for families of low and moderate income, including the elderly and handicapped.

Although our prime mission is to encourage the widest possible participation by private enterprise in providing housing for families of low and moderate income, we were created as a private corporation for profit. We, therefore, seek to produce maximum after-tax returns for our limited partners in the form of tax losses from our projects which can be used to offset taxable income from other sources.

There are numerous reasons for the very favorable trend in tax losses and the ratio of these losses to cash invested. The most important factor has been the continuing increase in the number of projects under construction and in operation. However, another major contribution to this trend has been our policy of deferring subscription calls through the use of temporary bank

loans. By keeping your cash investment down, we have been able to maximize your return.

In the face of mounting construction costs and taxes, a constantly shifting money market, and the energy crisis, NHP has employed federally subsidized housing programs as its principal tool to keep rent levels within the reach of low and moderate income families.

In order to attract venture capital to low and moderate income housing which can entail comparatively high risks and low cash rewards, Congress created a special tax inducement. The accelerated depreciation of residential structures and certain construction of residential structures and certain construction expenses become tax deductions which can be passed through to limited partners."

1975

The 1975 Report expressed concern about a possible cutback in the Tax Incentives in the legislation then being considered - which later became the Tax Reform Act of 1976. It stated (pp. 2-3):

"Retention of Tax Incentives

Of fundamental importance to the development of low - and moderate - income, housing by private enterprises is the current system of Tax Incentives to attract equity capital from private investment sources.

It allows investors to use tax losses to offset taxable income from other sources. Since cash return is limited by law and economic reality, the tax incentive is the only available means of gene-

rating high-risk capital to finance projects with high social priorities.

That exemption in our tax laws is under review by the Congress and is in jeopardy of being drastically cut back. If it is, the federal and state capacity to support housing programs for low and moderate-income families will be largely undermined.

We regard the changes under consideration to be false economies, not effective reform. In the absence of any proven or even proposed alternatives, the tax incentive system must be retained.

The Staying Power of the Private Sector

Given the proper tools, private enterprise has demonstrated time and again that it has the capacity to produce good housing at affordable prices. Created by Congress, capitalized by investments from the private sector, the National Housing Partnership enters into partnerships with builders, developers and nonprofit and community organizations at local levels for the construction of housing."

As set forth in the text, the 1976 Act left in place the incentives for low and moderate income housing, while cutting back on the tax benefits of other forms of real estate investment.

With respect to tax benefits, and their importance to NHP's efforts, the 1975 Report stated:

"As in previous years, NHP's yield will continue to come from the passthrough of its tax losses, and the use of these losses, by investors to offset taxable income from other sources.

For the first five full years or operations—1971 through 1975—NHP's annual tax losses averaged $26,600 per year for each $100,000 subscribed or 59% of cash invested. The figures for each year are as follows: 1971–25% 1972–52%, 1973–69%, 1974–68%; 1975–50%.

Of course any projection of future tax losses is based on numerous production and tax assumptions. Much depends, therefore, upon the success of the new federal programs and upon no significant changes in the existing tax laws or regulations as they relate to low - and moderate - income housing."

1976

The 1976 Report emphasized the importance of Tax Incentives as the crucial factor in motivating private investment in low and moderate income housing. It stated (p. 3):

"Development of low and moderate income multifamily housing by private enterprise is directly tied to the Tax Incentives that attract equity capital from private investment sources.

It allows investors to use tax losses to offset taxable income from other sources since cash return is limited by law. In economic reality the tax incentive is the only available means of generating high risk capital to finance projects with high social priorities.

In the 1976 Tax Reform Act, most of these income housing—but only during the next five years.

If the nation is to continue building decent homes for families of low and moderate income,

it is assumed that the Tax Incentives be extended or that a viable alternative be developed."

The Report summarized the tremendous amount of capital raised by the NHP based on the Tax Incentives, as follows (pp. 10-11):

"Equity Sales

Sale of NHP limited partnership interests in multifamily apartment projects enables NHP to roll over the investments in that it always has funds available for equity capital commitments to new projects. NHP equity capital commitments to new projects. NHP normally sells 95% of its interest in its projects through private placement offering memoranda. NHP retains its general partnership interest. Investors pay in installments over a period of several years. Sales are made primarily through investment banking firms which are members of the New York Stock Exchange, or directly by NHP Real Estate Securities, Inc., a subsidiary of NCHP organized in 1975.

In 1976, the dollar amount of such sales of interests in 22 housing projects increased approximately 5% over 1975, from $9,000,000 to $9,556,000. Since 1974, NHP has sold interests in partnerships owning 56 projects, for approximately $30,000,000.

Because the requirements for compliance with the private offering exemption provided by the Securities Act of 1933, NHP imposes investor suitability standards as to gross income, net worth, and investment sophistication, as well as a substantial minimum purchase amount.

Equity sales for 1977 are expected to be in excess of $20,000,000. NHP is confident, because of the credibility it has established, that it will continue to enjoy strong sponsorship from both the financial community and private investors.

NHP's yield continues to come from its pass-through of tax losses and the use of these losses by investors to be offset their taxable income from other sources."

1980

The 1980 Report discussed the NHP's increased involvement in housing rehabilitation -based on Tax Incentives as follows (p. 9):

"Renewed interest in historic preservation resulted in new tax regulation that provided incentives for builders and developers. Studies by the Department of Housing and Urban Development revealed a severe shortage of low and moderate income housing and also recognized that existing building stock in this country represents a massive investment in materials, labor, and time which should not be ignored. More recently, energy consciousness heightened the trend toward living in an urban setting. As a result of these factors, NHP has become involved in more rehabilitation projects in the past four years."

The Report further emphasized the importance of the pass-through losses to investors in the partnership format. It stated (p. 15):

"Conceived as an idea of organizing limited partnerships on a national basis, NHP began with initial capital of $42 million committed by 270 major corporations, financial institutions, and labor

unions. Additional capital for NHP operations is now generated from two primary sources: NHP's sales of limited partnership interests in multifamily rental projects and NHP's single-family sales housing activities both in joint ventures and as sole developers.

The primary forms of partnership fall into three general categories. In an equity purchase, NHP will buy up to 99% of the ownership. Tax losses and cash flow are shared with other partners in proportion to ownership."

1981

In the 1981 Report, the NHP described the importance of the increased Tax Incentives for low and moderate income housing enacted by the Economic Recovery Tax Act of 1981. The report also related the relationship between the increased Tax Incentives to NHP's ability to sell existing projects - thereby raising funds to finance new projects. The report stated (p. 5):

"To increase its profitability, NHP implemented a program of selling to limited partners under the provisions of the Economic Recovery Tax Act of 1981 some of the properties it holds in its portfolio that and not been previously syndicated.

As federal assistance programs, particularly the Section 5 program, have been eliminated or reduced, NHP has begun to develop new approaches to providing housing. In response to Section 8 cutbacks, NHP will be active in the acquisition of existing multifamily projects including those with government assistance.

These are projects which can be repositioned through syndication before or after rehabilitation, or through conversion to condominiums or cooperatives.

The acquisition and syndication or resyndication as of existing government assisted multifamily housing has been made feasible by the Economic Recovery Tax Act of 1981. This activity encompasses acquisition of projects built or rehabilitated over the last 10-15 years under HUD's Section 221(d)(3) or 236 programs. The acquisitions are being made either from profit-motivated or nonprofit sponsors.

In the case of projects which had been previously syndicated, NHP will acquire the interest from the existing limited partners. This provides a vehicle for older projects to continue to be attractive investments and thus be well maintained and preserved as a part of the housing stock over the long term."

1983

In its 1983 Report, the NHP stated (p. 1) that it had:

1) sold a record $91 million in equity to limited partners, representing an increase of more than 46% over the prior year;

(2) provided tax benefits to its original shareholders—partners—which benefits on a cumulative basis exceeded their original cash investment by 141%; and

3) in reliance on the increased Tax Incentives authorized in the 1981 Act, began full implementation of a new program of acquiring exist-

ing government - assisted housing projects and resyndicating them.

The Report referred to the need for continuing Tax Incentives in order that the initial investors in a project could, at some point, sell the project and realize a return of their capital. The Report stated (pp. 8, 17):

> "NHP developed and perfected its business pattern in 1982, and this will be the major area of concentration for the multifamily portion of NHP in fiscal 1984.
>
> The sale of these projects, developed and financed eight to 15 years ago under the Section 221(d)(3) and 236 programs of the Department of Housing and Urban Development, now not only offers benefits to the seller and buyer but also makes good sense form a public policy point of view. With substantially depleted depreciation benefits, sellers are recognizing the opportunity to immediately receive cash to offset their federal tax liability,
>
> The structure of the purchase and sale transaction is of paramount importance. To satisfy the requirements of buyer, seller and NHP these transactions are structured first and foremost to preserve the underlying below-market HUD insured mortgage.
>
> Part of the Company's success in 1983 came from the syndication and sale of certain properties which were owned by the Company and previously carried as an investment. These sales were made to take advantage of favorable conditions in the tax shelter market. A number of additional properties are owned by the Company. Sub-

ject to market conditions, it is our intent to syndicate and sell them during 1984 and 1985."

1985

The 1985 Report set forth the adverse impact on the ability to raise equity capital for low income housing of the tax law changes made in the Tax Reform Act of 1984 and the far more adverse changes proposed by the Treasury in 1985.[1]

The Report stated (pp. 6, 13):

"In 1985, NHP continued the acquisition started in 1984 of existing government-assisted housing properties.

Unfortunately, the Tax Reform Act of 1984 eliminated the ability to accrue interest which was a vital part of this program since low and moderate income housing cannot afford to carry any additional debt on a current basis. This change in law at a time when no new low and moderate income housing is being produced is but a further example of the lack of housing leadership.

Because of the 1984 Tax Act, future resyndication activities will involved either acquisition from non profits or substantially changed business terms to the sellers. For these reasons, volume under the acquisition program is anticipated to be dramatically less next year than experienced in the past two years.

[. . . B]eginning in 1981 with the termination of federal housing production programs, the Company shifted its primary focus from development

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[1] For example, slower depreciation, and a higher minimum tax.

to the acquisition of existing government assisted low and moderate housing. After December 31, 1984, acquisitions of this type were adversely impacted by provisions of the Tax Reform Act of 1984, and this program is now largely supplanted by the Company's activity in the development or acquisition of new market-rate rental apartments.

The Company had a record year in developing and acquiring property and in raising equity from investors.

Even with this record activity, sales slowed in the first months of calendar year 1985 (traditionally slow months for equity sales) after the Treasury Department announced its proposals for reform of the nation's tax code.

Inventory of housing held for sale increased from $26 million to $48 million the Company positioned itself to take advantage of existing tax laws before certain changes in the 1984 Act became effective. This strategy should reap rewards in fiscal 1986 unless further changes in tax laws reduce their benefit.

Our forecasts indicate that 1986 will be another good year. Our only reservation to optimism at this time is the possible impact of tax legislation which could reduce our ability to raise equity from investors. Much depends on both the specific provisions of any tax legislation and upon transition provisions and dates when they would become effective.

The 1984-1985 proposals turned out to have a less adverse impact on low and moderate housing than the passive loss provision enacted in 1986."

1987

In its 1987 Report, NHP stated that it currently owned or operated almost 80,000 total units; of which almost 60,000 units in over 400 properties were produced and are still operated under a variety of federal and state housing programs. NHP was also one of the largest property managers of multifamily housing with over 56,000 units under direct management (inside cover page (unnumbered)). This tremendous investment by this quasi governmental agency had been motivated by the tax advantages.

In the 1987 Report, NHP expressed great concern about the loss of Tax Incentives for low income housing. It stated (pp. 2-3):

> "Unfortunately, our past concerns have come into sharp focus with passage of the Tax Reform Act of 1986.
>
> NHP supported tax reform in 1986, with the caveat that incentives be retained for low income housing. No significant incentives were provided, and the law, by eliminating retroactively the tax advantages which had led to the investment of over $650 million in equity for NHP projects, casts serious doubt on the reliability of future federal tax legislation.
>
> The tax act has an adverse effect on both the development and preservation of low and moderate income housing. Development of new low income rental housing in any measurable volume has become economically impossible and it appears that the relatively small number of rental units likely to be built will require foundation and to her grants to support local incentives. NHP expects to participate in these and related efforts,

but important as such efforts will be, total national production will be limited.

Because of the anticipated decline in development, maintenance of the existing stock of low and moderate income housing assumes ever-increasing importance. Without Tax Incentives, however, it will be difficult for many owners of low income housing projects to justify the investments required for the continuance of proper maintenance programs. Similarly, the existing stock of low and moderate income rental housing is threatened by the future termination or expiration of existing subsidy contracts, and by the approach of the time periods in which federally subsidized projects can be converted to market rate use.

One painful byproduct of tax reform was a major reduction in force. We gave severance notices to approximately 20 percent of our headquarters employees. One change was of great importance symbolically–the elimination of our direct placement tax shelter sales group. The decision to end direct placement tax shelter based syndication emphasized our reliance on institutional and public sources of capital." (Emphasis added).

As quoted in "Washington Business" (p. 1, Col. 1), of The Washington Post of March 24, 1986, J. Roderick Heller, NHP President, stated:

"There's no way to provide low - and moderate - income housing without subsidies and tax benefits and Congress is eliminating them [. . . W]e cannot build only low-income housing without federal subsidies and with tax reform coming. I think it is inappropriate for people to think that

NCHP can be a charitable institution." (Emphasis added).

Mr. Heller further stated that over the course of the 1980's, the basic "meal tickets" of NCHP "were wiped out":

> "One was the federal subsidies that made the production of low-income housing possible. Between 1981 and 1985, HUD saw its funds for housing assistance but from $32 billion a year to $10 billion, the biggest reduction in any domestic program.
>
> In addition, the Reagan administration's initial tax-reform plan, and the subsequent congressional plans, propose to eliminate many of the traditional Tax Incentives for investing in low- and moderate-income housing. [. . . U]nder the circumstances, they [NHP] insist that there is little they will be able to do to produce new housing for very low-income persons."

EXHIBIT L

ARTICLES REGARDING OPERATING DIFFICULTIES AND RESULTS OF LOW AND MODERATE INCOME HOUSING

Defaults Likely to Reduce HUD Apartments; Cisneros Tells Senate Panel 'Multifamily Crisis' Calls for Easing Rules on Sales of Projects

Guy Gugliotta, Washington Post Staff Writer

The Washington Post June 23, 1993, Wednesday, Final Edition

Secretary of Housing and Urban Development Henry Cisneros painted a grim picture yesterday of the agency's troubled housing programs and outlined corrective measures that could limit the nation's potential supply of low-income rental apartments.

Cisneros said the department is attempting to sell off 444 housing projects it expects to own by the end of the year because of defaults by private developers whose mortgages were insured by HUD. In order to sell them, federal law requires the department to provide rental subsidies for low-income tenants in the projects. That would cost $ 3 billion to $ 4 billion, but Congress has appropriated only $ 93 million for that purpose this year.

Cisneros said because of the overall federal budget squeeze, "asking for more money is just not in the cards."

Without funds, HUD's only recourse is to seek changes in the law so that it can sell the buildings with fewer subsidies. In those circumstances, a net loss of subsidized units nationwide appears to be certainty.

HUD officials later noted, however, that some HUD-owned projects slated for subsidy were in such grim condition that they could not be renovated without an assurance they could be sold. Selling them with fewer subsidies, the officials said, would be better than letting them lie derelict.

The new measures were outlined only vaguely during testimony by Cisneros before the Senate Banking subcommittee on housing and urban affairs, hut they appeared to be the principal tool the agency plans to use in the short run to resolve what Cisneros described as "HUD's multifamily crisis."

Cisneros pulled no punches about the crippling problem HUD faces in managing its interests in 18,000 housing projects nationwide: "This problem is complex and costly," he told the subcommittee. "It has taken a long time to get into this mess, and it will take a long time to get out."

Last week HUD's inspector general reported that the Federal Housing Administration, a HUD agency, needed $ 6.8 billion to pay anticipated claims on housing project mortgages that it insures. The losses could reach $ 11.9 billion during the next few years — 27 percent of the insurance that HUD provides for some 15,000 privately owned housing projects.

But, Cisneros explained, this is only the first aspect of the crisis. When HUD takes over the troubled mortgages from banks — HUD holds 2,200 such mortgages now — its own regulations make it even more difficult for landlords to meet their payments. Meanwhile, HUD loses money, while owners, either of necessity or by design, let projects fall to ruin.

Eventually HUD completely takes over the worst projects, but foreclosure is a reluctant step, because

of current subsidy regulations: "Without a real threat of foreclosure" projects are likely to deteriorate, Cisneros said yesterday. "The developer knows we can't act, so he let's the project go because we're powerless."

HUD typically participates in the development of privately owned low- and moderate-income housing projects by insuring the mortgages through the FHA and by providing "Section 8" rental subsidies for low-income residents of the projects.

Under Section 8, low-income tenants pay 30 percent of their income as rent, and HUD pays the owner the difference between that amount and the posted rent. A project may have no subsidized apartments, all subsidized apartments or anything in between.

As an assured source of income, Section 8 has served as an inducement for developers to enter the low-income market. But as the insurer of the projects and provider of Section 8 subsidies, HUD is responsible for monitoring the loans and insuring that owners maintain the buildings in compliance with the law.

HUD's current crisis began in the late 1980s. Experts, both inside and outside HUD, agree that the seminal event was probably the Tax Reform Act of 1986, which transformed such projects from one of the nation's favorite tax shelters into dangerous, iffy investments.

The act changed the rules by which owners could depreciate housing projects on their income tax, lessening the immediate tax advantages for investors. When regional economies nosedived in the late 1980s, landlords began to feel the pinch. When the

national economy altered in 1991, the squeeze became general.

"There was an inability to attract money into projects because there were no longer any tax benefits," said Washington lawyer Carl Coan, who specializes in HUD and other real-estate-related matters. The Tax Reform Act of 1986, he said, "dried up the sources of money."

Besides their financial difficulties, owners also began to neglect maintenance and other obligations, in part because HUD's chronic staff shortages, haphazard record-keeping and inadequate computer systems made it impossible for the agency to rigorously monitor individual projects.

The inspector general's report said this occurred, however, "not as a result of complacency, but rather because they [HUD employees] lacked the resources to do so." HUD had 14,331 employees at the end of 1992, 2,000 fewer than in 1981.

By this year, the report said, HUD's regional caseload ranged from 28 projects per employee "servicer" in Kansas City, to 105 projects per servicer in Detroit. State agencies doing the same work had ratios of 16.5 and 12.5 projects per employee.

"For each property the servicer is expected to watch the financial situation, the occupancy rules, the management and the physical condition," said a regional HUD supervisor in Fort Worth. "They also do casualty inspections, promote sales, negotiate workout agreements [to modify mortgage terms] and handle calls and complaints from owners and residents."

Cisneros acknowledged yesterday that "we do need additional people," but held out little hope for staff expansion during the current austerity period. Instead, he said, HUD planned to reorganize, reallocate and retrain employees.

FHA insures about 15,000 housing project mortgages worth $ 48 billion nationwide, by far the largest chunk of the 18,000 projects in which HUD has some sort of obligation.

This year the Washington accounting firm Coopers & Lybrand completed the first-ever risk analysis of the insured properties. Of the 15,000 projects, HUD sources said, 398 were either delinquent or in default to private banks, and another 1,235 were listed as "troubled."

When an owner defaults on his mortgage, his bank may try to help him "work out" a new payment schedule or find him a new investor or even a buyer. This task has become increasingly difficult since 1986, however, so banks have elected to escape the deal altogether by "assigning" the mortgage to HUD, which pays the bank 99 cents on the dollar and takes over the note.

The Coopers & Lybrand study found that far more of the mortgages were in danger of assignment than HUD foresaw, requiring FHA to put $ 6.8 billion into its loss reserve to cover expected insurance claims which the inspector general said could reach $ 11.9 billion over the next few years.

Once HUD assumes a mortgage, it behaves as a bank, looking for investors and attempting workout agreements. HUD workout regulations, however, demand that landlords be current on their delinquent loans — including arrearages — within three years,

and that they invest 5 percent of the original mortgage amount in property repairs and maintenance. This scheme, many experts believe, is much too rigid.

"HUD focuses on looking for the landlord to come in with a plan that complies with the regulations," said Charles Wilkins, president of the National Assisted Housing Management Association. It would he better in many cases, Wilkins suggested, to focus on plans that comply with landlords' ability to pay. HUD, he added "is working in reverse."

HUD has some flexibility, but negotiating exceptions to the regulations takes time and sophistication, and "HUD has more of these properties than they have staff to deal with," said Wilkins, whose organization represents the managers of HUD-assisted properties.

One HUD employee in Dallas described working full time on a single housing project for months, not an uncommon occurrence, HUD officials say. "We're short-handed in all departments," said one Fort Worth HUD official. "You get a big project in trouble, and you have a political situation at the same time you're dealing with finances and tenant complaints."

FHA Commissioner Nicolas Retsinas said the agency soon will promulgate new guidelines for HUD-held mortgages. Among other things, they will in some cases extend the workout period to six or even nine years. Regional officials in Fort Worth said this could help absorb some of the delinquencies, but expressed doubt that it could clean up large numbers of loans that were already in trouble when HUD acquired them.

Whatever happens, it is clear that the current system does not work. On May 20, Fort Worth's

regional office, covering Texas, New Mexico, Oklahoma, Arkansas and Louisiana, held 338 housing project mortgages, of which 240 were delinquent, but only 16 under workout.

Without a workout, HUD is supposed to foreclose and take over the property. In reality, however, the agency most often temporizes, because ownership brings another set of headaches, Retsinas said.

Yet stalling, he acknowledged, means HUD routinely carries delinquent projects with or without workouts, sometimes for years, as long as owners maintain the properties and pay some money. Fort Worth has 128 of its mortgages in this bureacratic limbo, "awaiting decision" as it is called. One regional supervisor said Fort Worth renegotiated workouts on one property for 17 years before foreclosing in 1992.

Foreclosure will occur, however, when HUD determines that an owner either cannot or will not make adequate repairs, hire adequate management, provide adequate security or adequately screen tenants. "When landlords start to let properties go, they aren't choosy about who lives there," said one regional supervisor. "Drugs and crime drive away the good tenants, and you lose your rents. Things just get worse faster."

These are the projects of legend. At Dallas's Park Congress Apartments, recently acquired by HUD, 8 of 79 units were occupied in June and the rest were in ruins, gutted by thieves, trashed by vagrants and open to the weather. The neighbors had unrolled razor wire along the boundary wall to keep drug traffickers at bay. It will cost $ 19,000 per unit to renovate Park Congress, but HUD will pay. Re-

placement costs in the Dallas-Fort Worth area run $ 32,000 to $ 42,000 per unit.

Yet once the work is done, HUD will have another building it cannot get rid of. Current law requires that any multifamily property that HUD sells must have 15 years worth of Section 8 rent subsidy attached to every unit that has a low-income tenant living in it. If a property is at least 51 percent low-income when HUD acquires it, it must be 100 percent subsidized when HUD sells it. HUD agrees with General Accounting Office estimates that it would need $ 3 billion to $ 4 billion in Section 8 to shed its inventory.

Cisneros said his legislation will seek "flexibility" in all of these requirements. He will ask for changes in subsidy regulations that would have the effect nationally of reducing the number of units requiring Section 8 subsidies before a project can be sold.

Cisneros noted that most of the current Section 8 requirements arose from a desire to ensure that low-income Americans' access to affordable housing would be protected by law. "In many ways, we are paralyzed by good intentions," he said.

Low-Income Housing Seen In Jeopardy; Panel: 523,000 Units May Be Lost by 2002

Ann Mariano, Washington Post Staff Writer

The Washington Post May 9, 1988, Monday, Final Edition

More than 500,000 federally subsidized housing units occupied by low-income Americans will be lost by 2002 unless action is taken to save them, according to a new study.

Preserving the housing for the poor would cost $ 17.7 billion over the next 15 years, the study said. As a comparison, the study said, rent-subsidy payments to occupants if they are forced to move would cost $ 21 billion over the same period.

Estimates of the number of endangered housing units have varied widely. The count by the National Low Income Housing Preservation Commission is based on computer analysis of detailed information on about 300 properties nationwide. The commission's study has been submitted to the House and Senate housing subcommittees.

The group's most striking finding is that 523,000 of the 645,000 housing units covered by the study are in "real jeopardy" of being lost through defaults or conversions, said commission cochairman Carla Hills, secretary of housing and urban development in the Ford administration.

The commission did not recommend who should pay the bills. That "is for Congress to determine," Hills said. The $ 17.7 billion cost would preserve the housing for 15 years, but "it is not a permanent solution."

The units studied are in privately owned rental apartment buildings receiving federal assistance. Restrictions tied to the federal subsidies will expire over the next 15 years, enabling owners to pay off mortgages, raise rents or convert the properties to condominiums. In other cases, owners will default as changes in tax benefits and expiration of rent subsidies reduce their income.

Without government action, owners of 43 percent of the properties probably will default, and owners of another 38 percent will pay their federally subsidized and insured mortgages, the report said. The buildings surveyed are subsidized by three of the earliest programs launched in the 1960s to encourage private developers, owners and managers to provide low-income housing.

In return for the subsidies, owners had to rent apartments to individuals and families with moderate incomes, defined in most cases as 80 to 95 percent of median incomes in their areas. In many cases, families with incomes so low that they could not afford even the lower rent were also given rent subsidies.

About 70 percent of the tenants in the 523,000 endangered units have incomes of less than half the median for their areas and cannot afford housing without government help, the report said.

The commission, sponsored by the National Corporation for Housing Partnerships (NCHP), recommended that the federal government take responsibility for preserving these properties for the poor by establishing a low-income housing preservation office within the Department of Housing and Urban

Development and staffing it with financial and legal experts to work with local governments.

The NCHP was authorized by Congress to encourage low- and moderate-income housing construction.

Another study last week estimated that the government would have to spend $ 97 billion over the next 15 years to provide adequate, affordable housing for all Americans.

This amount would be in addition to current levels of government subsidies, according to the Urban Institute study financed by the National Association of Realtors (NAR).

About 17.7 million households occupy housing that fails HUD's adequacy standards for electricity, plumbing and sewage disposal, and another 3.2 million are overcrowded, the study found.

The study estimated the levels of housing construction, investment and subsidies needed to eliminate physical deficiencies and provide adequate homes for new households for the next 15 years.

To house all Americans decently, 36 million units must be built or upgraded by 2002 at a cost of $ 41 billion beyond current subsidy levels, it said. Additional subsidies of $ 56 billion would be necessary to hold housing costs at no more than 30 percent of household income, it said.

An NAR official said action must be taken to enable more Americans to own homes. Ownership has dropped by 20 percent in the 1980s among those ages 25 to 34, said Nestor Weigand, NAR president.

Congress Urged to Spend $ 11.9 Billion to House Poor; Group Cites 'Decade of Federal Neglect'

Ann Mariano, Washington Post Staff Writer

The Washington Post October 17, 1987, Saturday, Final Edition

The National Association of Housing and Redevelopment Officials this week urged Congress to spend nearly $ 11.9 billion next year to house the poor, saying that amount is needed to "reverse a decade of federal neglect."

The figure does not include money for Community Development Block Grants and rural housing and development projects, which the association recommends funding next year at the current levels of $ 3 billion and $ 3.2 billion respectively. The Department of Housing and Urban Development received $ 13.5 billion for all of its programs for fiscal 1987.

Housing needs among low- and moderate-income Americans have "increased dramatically," but "the federal government has been engaged in a headlong retreat from its once-strong commitment to the goal of a decent home and suitable living environment for every American," said Melvin 3. Adams, NAHRO president and director of development for the Montgomery County Housing Opportunities Commission.

The HUD budget has been reduced by nearly 70 percent since President Reagan entered the White House seven years ago, cutting deeply into some low-income housing production and rehabilitation programs and killing others. Congress gives the department more money than it asks for each year, but has not been willing to fund the agency's programs at the higher levels of the 1970s.

Now, however, "Congress is beginning to recognize that housing and community development has taken a disproportionate share of budget cuts," Adams said.

NAHRO delivered its recommendations to Sen. Alan Cranston (D-Calif.), head of the housing subcommittee of the Senate Banking, Housing and Urban Affairs Committee, who asked housing organizations and advocacy groups, developers, and academics for legislative proposals. Cranston and Sen. Alfonse M. D'Amato (R-N.Y.) say they hope to introduce a major housing bill in the next Congress.

The association, which represents 2,400 public housing authorities and community development agencies, believes state and local agencies should get much of the money it is recommending for housing programs.

The funds should come without strings, so assistance can be tailored to meet local needs, "replacing rigid national programs," the association said. The association's proposals also include a "flexible rental assistance" plan and a block grant program for low-income housing construction and rehabilitation.

The NAHRO plan calls for restoration of tax incentives that attracted developers and investors into low- and moderate-income housing construction. Many of the benefits were eliminated by the 1986 tax law.

A "new federal, state and local partnership for long-term investment programs" to improve communities also was proposed.

In addition, the organization urged "immediate federal action" to keep several hundred thousand existing units of privately owned, federally subsidized

housing within the financial reach of low-income households. Requirements that the units be rented to low- and moderate-income families, a condition for receiving the federal subsidiaries, will expire on these units during the next 15 years.

The association said 2 million units disappeared from the nation's supply of low-income housing between 1974 and 1983 because of deterioration or conversion to market-rate housing.

The group said nearly 8 million more low-income units will be needed by the year 2000.

Less than 20 percent of individuals and families eligible for government housing aid now are receiving it, and among the millions living in private units, 14.4 million households pay "well over" 30 percent of their incomes for rent, Adams said.

A "first-time home buyers savings plan" would be established under NAHRO's plan to help low- and moderate-income families purchase houses. Under the NAHRO program, the Fair Housing Act of 1968 would be amended to strengthen enforcement of its provisions.

Sale of Mitchell-Lamas for Profit Endangers Subsidized Housing

The New York Times
May 2, 1987, Saturday, Late City Final Edition

SECTION: Section 1; Page 26, Column 4;
Editorial Desk

To the Editor:

David Kahn is in substantial error in stating that occupants of apartments built under New York State's 1955 Mitchell-Lama program are not subsidized (letter, April 10). The essence of the program was a below-market mortgage loan from the city or the state. The developer-owner or the cooperators put up 5 percent of the development cost, with city or state (taxpayers) putting up 95 percent at the below-market mortgage rate. This is a very substantial subsidy, to which is added tax abatement. Many Mitchell-Lamas also enjoyed additional subsidy by reduction of land cost through urban renewal mechanisms or sale by the city at below-market price.

These subsidies were justified by the need to provide affordable housing for middle-income people that would remain at rents and carrying charges that middle-income people could meet, not to provide a jackpot for those who enjoyed subsidized Mitchell-Lama occupancy.

Mr. Kahn is also in error on the "right to opt out." It is specifically stated in the prospectus that a cooperator on leaving must sell his unit back to the development for the equity amount (5 percent) he put up.

His arguments on underuse of apartments and failure of tenants and cooperators to pay overincome

surcharges, far from favoring his claim to sell at market price, point to the need to enforce Mitchell-Lama regulations. Public funds were not meant to subsidize extra guest rooms or exempt overincome occupants from paying surcharges required by law.

Many Mitchell-Lamas defaulted on their mortgage payments for failure to collect those surcharges. Those defaults played a role in the city and state fiscal crisis of 1975, when the Mitchell-Lama program ended. Efforts to collect surcharges by monitoring were defeated in the City Council through pressures of the Mitchell-Lama constituency.

Mitchell-Lamas should not be sold on the open market to give a financial profit to the occupants. To permit this simply feeds the opposition of the Reagan Administration and others to much-needed programs to build subsidized low- and moderate-income housing.

HARRY J. BYRNE

The Upcoming Crunch In Low-Income Housing; End of U.S. Restraints May Cut Availability

Ann Mariano, Washington Post Staff Writer

The Washington Post April 4, 1987, Saturday, Final Edition

Washington area governments, already grappling with severe shortages of homes for their poorest citizens, soon will face another housing problem.

Several thousand privately owned, federally subsidized low-income housing units in the metropolitan area and 200,000 of the estimated 600,000 such units throughout the nation could be beyond the economic reach of poor Americans within the next five years, according to Congressional Budget Office figures.

Within 15 years, 60 percent of the national total will be free of the regulatory restraints that ensured their continued use as low- and moderate-income housing. Owners will be free to convert them to condominiums or high-cost rentals if they choose. Housing experts said the temptation to convert them will be strong in several major metropolitan areas, including Washington, where property values have risen sharply in many neighborhoods.

Developers built the housing beginning in the 1960s using interest-rate subsidies provided by the Department of Housing and Urban Development. In return for the financial aid, owners agreed to rent the units to poor families for 40 years, but are allowed to prepay their mortgages at the end of 20 years and free themselves of the obligation to house low-income families.

Owners of more than 2,000 apartments in the District can pay off their loans within the next five

years, according to HUD. Another 5,900 units could be eliminated from the low-income housing stock in the following 10 years, the department said.

A spokesman said HUD was unable to provide figures for other Washington jursidictions, but Fairfax County officials estimated that owners of about 900 apartments, a quarter of the county's supply of low-income housing, could rid themselves of federal restrictions within the next five years.

In booming Fairfax, rents in most of these buildings could jump from the present range of $ 200 to $ 300 a month up to $ 600 to $ 700 if owners decide to prepay their loans, according to Bob Counts, program planning director for the Fairfax Department of Housing and Community Development.

The loss could be serious for high-cost Fairfax, where low-cost housing is in such short supply that officials have at times closed their waiting list for assisted units. The list is open now, and contains about 2,300 names.

Estimates of the number of Fairfax families who are not seeking housing assistance but are paying more than 30 percent of their incomes range from 13,000 to 27,000, according to John J. Castellani, chairman of the Fairfax Redevelopment and Housing Authority.

Fairfax officials hope to find "innovative ways" to deal with the problem, including county- or state—financed loans or other types of subsidies to owners who will agree to keep rents within the reach of poor residents, Castellani said.

Counts said Fairfax authorities hope to "avoid the Arlington and Alexandria type situations." Conver-

sions of apartment projects, which are displacing low- and moderate-income residents, have touched off bitter controversies in both areas recently.

Montgomery County's stock of privately owned subsidized housing is newer, with the first property coming to the end of its restrictions in mid-1991. Within the following seven years, 2,482 units could be sold or converted to higher-cost uses. Scott W. Reilly, senior planner for the county's housing and community development department, said most of the properties are in "up county" areas where land values are not escalating rapidly, but added "in 1991 there may be more redevelopment pressure."

Nationally, subsidized housing in the hands of private owners provides homes for more than 2 million Americans and represents a major portion of the 1.9 million low-income units assisted by the government. Critics say that much of the $ 11 billion federal investment in subsidized housing is in jeopardy, raising the specter of enormous costs in dollars and in the suffering of poorly housed and homeless citizens.

Witnesses at hearings before the House Housing Subcommittee said it was impossible to predict with any certainty what decisions private owners will make when the restrictions expire on their property. Several noted, however, that many low-income housing projects are located in older metropolitan areas where land values have risen with the increased pace of redevelopment.

Cutbacks in federal housing programs and reduced tax benefits may encourage owners of projects in strong markets "to convert to market rentals or some alternative use," according to Neal P. Curtin of the

General Accounting Office. And without federal assistance, owners in weak market areas may allow projects to deteriorate because they are unwilling to spend more money to maintain the property for low-income occupancy, Curtin said.

The Council of State Housing Agencies estimates that owners of as many as 200,000 units would benefit economically by selling their properties or converting them to condominiums or market-rate rental buildings in the next few years, according to James Logue, executive director of the New Jersey Housing and Mortgage Finance Agency.

A government study indicates that about 75 percent of the units will remain in the low-income housing stock, Thomas T. Demery, HUD's assistant secretary for housing, told the subcommittee. He said the department will provide rent-subsidy payments for poor Americans forced out of their apartments and search for "owner incentives" to keep other properties in the low-income range.

Demery said that in tight housing markets, where finding new housing for displaced tenants is difficult, "state and local governments ought to respond because there is simply no justification" for a national rental housing construction program.

Testifying on behalf of the Association of Local Finance Agencies, Walter Webdale, director of the Fairfax County Housing and Community Development, said legislation pending in Congress would give state and local governments the right of first refusal to buy projects. But he said these jurisdictions need more help to retain the units in the low-income housing inventory.

Among the solutions proposed is congressional reinstatment of some of the real estate tax benefits taken away by the 1986 tax reform act. Amy S. Anthony, Massachusetts' secretary of communities and development, said renewed tax incentives could be used to reward owners who cooperate in the effort to keep their projects within the rent range of low-income households.

Anthony also suggested that property owners "be required to analyze the impact of prepayment on their tenants and to show how they are going to handle relocation." She proposed patterning regulations on a Massachusetts condominium conversion law that makes owners responsible "for the impact of a change in ownership form" and mandates up to two years' notice to tenants and state and local governments.

Keeping housing in the low-income inventory and protecting displaced tenants are equally important, according to Anthony. She cited National Association of Home Builders estimates that subsidized rental housing units would cost about $ 40,000 to build at today's costs. If all the subsidized housing units in the country were replaced, the tab would be $ 130 billion, according to the builders' association.

In the "tight Massachusetts real estate market . . . the vast majority of the 7,500 units" in the state will be "ripe for conversion to market rate rental or condo ownership" by 1991, Anthony said.

Marilyn Melkonian, president of Telesis Corp., a private company working with affordable-housing groups and local governments, said she believes that "a more immediate problem" than housing on which use restrictions are expiring is privately owned units

receiving Section 8 rental subsidies. Owners receiving these subsidies can "opt out" of their commitment every five years, she said.

Logue said that another 360,000 low-income apartments built with state financing and insured by state governments will face expiration of use restrictions in later years.

Local Subsidized Housing Projects Come Up Short
Boston Business Journal October 20, 1986

Byline: Sue Reinert

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October 20, 1986

Proposed Massachusetts housing projects for low- and moderate-income families are facing financial shortfalls despite special consideration afforded by the recent federal tax reform bill.

Patrick Clancy, executive director of Greater Boston Community Development, said last week that even with the favorable treatment approved by Congress, developments in the state will lose 25 to 50 percent of the funds they had expected to raise from syndication. Clancy's agency is involved in many of the affected projects as a developer or consultant.

Until tax reform, syndication was an important source of funds for the development of affordable rental housing. Developers could sell project losses and other tax credits to investors, who bought shares in the projects to obtain tax exemptions that were worth more money than the investors had put up. The new tax law wipes out most of those tax credits, giving investors no incentive to buy shares. A spokeswoman for the Massachusetts Housing Finance Agency (MHFA), which administers

State Housing Assistance for Rental Production (SHARP), the state's rent subsidy program, said MHFA is happy about winning special tax credits for SHARP projects, "but we're not homefree by any means." She said MHFA met with SHARP developers two weeks ago to assess the situation.

The most striking example of the tax law's impact is seen in the complicated Columbia Point project.

Despite a special tax credit afforded Columbia Point and designed to offset the loss of credits as mandated by the new law, Columbia Point developer Joseph Mullins said he needs an additional $ 30 million loan to make the mixed-income development work.

Originally, Mullins, the head of Corcoran, Mullins, Jennison Inc., expected to raise $ 30 million from syndication. But now, according to a summary presented to MHFA, syndication proceeds could be as low as $ 15 million, even with the favorable tax treatment.

Mullins also said that because of uncertainty about the new law, it will take at least three months and as long as a year to carry out the syndication.

The solution to Mullins' problem — a solution that was still falling into place last week — involves state aid, future linkage payments to the city and personal pledges from the developer.

About two months ago, in anticipation of the tax package's impact on syndication, Mullins asked MHFA (which last year approved a low-interest mortgage of $ 121 million for Columbia Point) to loan $ 30 million more. MHFA approved the extra amount last month, but only on condition that half of the loan be backed by additional collateral. The other $ 15 million would be added to the previous mortgage and paid off over 30 or 40 years from project revenues.

A complicated scheme for the $ 15 million in collateral, called the "Trilateral Plan," was devised by MHFA officials, Mayor Ray Flynn's office and the

Boston Redevelopment Authority (BRA). It calls for $ 5 million of the collateral to be pledged by the developer, $ 5 million to be put up by the state from the SHARP program and $ 5 million to come from linkage payments owed to the city.

In order to carry out the plan, the BRA and the mayor had to find downtown developers to "propose" that their linkage payments be used as collateral for the Columbia Point project. Three projects were tapped: 150 and 160 Federal St., and 1 Franklin Place.

"We weren't strong-armed," said John B. Hynes, the developer of 1 Franklin Place. In letters that were almost identically worded, Hynes and Thomas Phelps, the developer of the Federal Street projects, made their "housing creation" proposals.

The city ordinance establishing linkage requires that at least 70 percent of the money go to low- and moderate-income housing. The 1282-unit Columbia Point project, on the other hand, will be 69 percent market-rate apartments, with 400 units reserved for low-income families. Nevertheless, the housing creation proposals were approved by the recently established Neighborhood Housing Trust on the morning of Oct. 9 and by the BRA the same afternoon.

City Council president Bruce Bolling, an ex-officio member of the Neighborhood Housing Trust, said that since the 400 low-income units wouldn't be maintained without the financing plan, the project met the requirements of the ordinance. Deputy corporation counsel Albert Wallis refused to comment on the issue.

Under the plan, the linkage money — which hasn't even been paid to the city yet — will be released from

the collateral obligation to MHFA as soon as syndication proceeds reach $ 10 million. If syndication fails — a contingency that Mullins and others virtually ruled out — Hynes and Phelps would make their linkage payments, scheduled over 12 years, to MHFA.

The new financing plan is awaiting final approval by the US Department of Housing and Urban Development (HUD). HUD has authority over the scheme because the agency has made a $ 12 million grant to the project. A HUD spokesman said action is expected this week.

"We're confident we can syndicate the project," said Mullins. "We just need some time to put it together."

Meanwhile, another large, complicated project that has also been years in the planning — Tent City — likewise faces a cash shortage because of the tax law, according to Clancy, who wouldn't disclose the amount of the shortage. Originally, about 15 percent of the funds for the $ 30 million project, or $ 4.5 million, was to come from syndication.

Under tax reform, Clancy said, the dilemma facing developers of affordable housing is deciding which tax breaks to use, breaks to use because all have drawbacks.

TAX REFORM: HITTING SOME PEOPLE RIGHT WHERE THEY LIVE

Andre F. Shashaty. Andre Shashaty is senior editor of Multi- Housing News, a national housing trade magazine published by Gralla Publications in NY

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With the November elections just around the corner, almost every member of Congress will be taking credit for the "historic" reform of the nation's tax laws. To hear congressmen tell it, they have struck a blow against the fat cats who pay nothing in taxes and for average Americans who pay too much.

But who will pay for the new tax liabilities the tax reform bill imposes on investors and corporations? The same people who are supposed to be the beneficiaries of tax reform, especially low- and moderate-income renters too poor to take advantage of the untouched tax breaks for homeownership.

Ever since our government started financing public housing in 1937, decent housing for every American family has been a top federal policy goal. Then the Reagan administration slashed direct housing subsidies to a tiny fraction of their historic levels to help pay for more missiles and bombs.

That left a housing policy based almost solely on tax incentives, including several very generous provisions passed in 1981. Then the Senate Finance Committee, led by Chairman Bob Packwood, came after those incentives with a vengeance that bordered on hysteria. It's as if they finally realized that the tax

bill they passed in 1981 allowed investors to avoid taxes.

Those incentives were passed to encourage investments with a public purpose—to help provide low- and moderate-income housing. Although many investors avoided taxes, thousands of units of rental housing were built at relatively affordable rents. Now that those incentives have been eliminated, rental housing investors will insist on a higher cash return. That means higher rents.

Because most renters spend more on rent than on taxes, even a small rent hike will exceed the average tax cut they will receive under the tax reform bill. Meanwhile, home buyers will continue to enjoy lucrative deductions for mortgage interest. Property taxes also remain deductible.

Tax reform also will mean a decline in new construction, since rents are not likely to increase fast enough to make new buildings worthwhile under the new tax law. The National Association of Home Builders predicts that multifamily housing starts will drop by as many as 350,000 units in the first year after passage of the tax reform bill. Hundreds of thousands of jobs will be lost as a result. Owners of existing properties who cannot get rent increases will see the value of their properties drop. More and more owners might default on their mortgage loans or simply abandon their properties.

Certainly, there is some truth in the tax reformers' contention that tax incentives for housing were too generous and needed trimming. Previously enacted tax breaks have generated overbuilding in many areas, and more than a few projects have been built primarily to shelter taxes, not tenants.

Yet, after years of debate, the final tax bill was shaped by the demands of revenue neutrality, not by policy considerations. The bill has demolished the last remnants of a federal commitment to housing that has spanned political upheavals over 50 years.

True, the legislation offers a modest tax credit for development of low-income rental housing. But it also imposes crippling limits on tax-exempt bonds, one of the primary tools for financing low-cost apartments. Most housing experts do not expect either incentive to produce much housing in the absence of direct subsidies.

Meanwhile, developers are already planning more conversions of rental apartments to condominiums. They know that tenants will realize ownership makes more sense under the new tax law—if they can afford it.

Hard Times for Subsidized Housing; Washington Firm Struggles to Fund Projects for Lower-Income Residents

Michael Abramowitz, Washington Post Staff Writer

The Washington Post March 24, 1986, Monday, Final Edition
SECTION: Washington Business; F1

Just inside the Capital Beltway in Fairfax County, the remnants of the Great Society can be found at Strawbridge Square, a complex where low-income families have been living since 1979 in 128 apartments and town houses built under the so-called "Section 8 program," a longtime mainstay of federal housing assistance programs.

"You would never know it is an assisted community. It looks just like it did the day it was finished," said Virginia S. Peters, head of a Methodist Church community group that helped plan and run the project. "Strawbridge Square is our pride and joy. We point to it as a model of community development in this nation."

Much of the responsibility for Strawbridge, Peters said, goes to the National Corporation for Housing Partnerships (NCHP), a little-known Washington company that has become the country's largest owner of low- and moderate-income housing since it was created by Congress in 1968. NCHP's companion, the National Housing Partnership, provided some of the start-up funds for the $3.6 million project, covered $500,000 in cost overruns as the project was being built, and continues to manage the Strawbridge Square units.

There are few Strawbridge Squares under construction anymore, however. Federal support for low-income housing, through such programs as Section 8, has withered under the Reagan administration. Many of the tax incentives for investing in low-income housing, furthermore, are being threatened by the tax-reform proposals now under debate on Capitol Hill.

The result has been difficult times for NCHP; as well as the other groups that traditionally have capitalized on federal programs to develop housing for poor- and middle-income people.

Though NCHP has in recent years begun to make money for the first time since it was created, its ability to fulfill its unique federal mandate of funneling private investment into low-income housing — while turning a profit — has been sorely put to the test.

But executives are hoping for a change in fortunes after a major corporate restructuring and capital infusion announced last week. The company said it received new capital of $36 million from subsidiaries of Weyerhaeuser Co., the Washington State forest-products firm, and Berkshire Hathaway Inc., the Omaha holding company headed by investment guru Warren E. Buffett.

The company also has been quietly mapping out new strategies for coping with the reduced federal involvement in housing. Some outsiders, who say NCHP has not been as aggressive as it should be, fear that the company will move progressively away from its congressional mandate and operate like a traditional real estate developer. Company executives

deny that, but say they are simply taking pragmatic steps to ensure that they can carry out that mandate.

"There's no way to provide low- and moderate-income housing without subsidies and tax benefits, and Congress is eliminating them," said J. Roderick Heller, NCHP president and the driving force behind the recent recapitalization. "I don't want to suggest for a moment that we're not going to take risks. But we can not build only low-income housing without federal subsidies and with tax reform coming.

"I think it is inappropriate for people to think that NCHP can be a charitable institution. We have to become profitable and thriving," added Heller, who joined the firm last year.

Certainly both profitability and social progress were among the goals sought by the creators of NCHP in the late 1960s. The company was organized under a congressional charter in 1970, after a special commission established by President Lyndon Johnson had recommended the creation of private groups to encourage private industry to participate in producing housing for low- and moderate-income families.

Although tax-sheltered real estate syndications are now plentiful, the basic premise of the NCHP was unique at the time.

Housing Investments Sought

The idea was to set up partnerships which would invest in low- and middle-income housing projects in which the principal economic benefit for investors would be tax losses. The grease for the system was various federal programs that subsidized the con-

struction of this housing, although NCHP itself never has received any direct federal assistance.

For a time, the system worked reasonably well, and NCHP carved out a small but important niche in the industry, according to real estate experts.

With $42 million in initial investment provided by 270 companies and organizations — some of whom simply wrote the contribution off as charity, according to Heller — the housing partnership has become the general partner in nearly 500 development projects around the country. Over the years, the company has raised about $540 million from 6,500 investors in these projects.

These projects contain almost 80,000 units, mostly apartments, while the company's property management subsidiary also has some 50,000 units under its direct management. Two dozen of NCHP's projects dot the metropolitan Washington landscape, including Strawbridge Square, the Foxchase complex in Alexandria, and Congress Park, a government-owned housing project in Anacostia that was redeveloped by the partnership in the early 1980s.

"NCHP has basically fulfilled its role," said Carl A. S. Coan, a Washington attorney who served at the Department of Housing and Urban Development (HUD) when the company was created. "It has been a very substantial producer or participant in the production of low-income housing."

As he quickly added, though, "There are certain points beyond which even the angels of the world cannot go without federal assistance." Indeed, over the course of the 1980s, the basic meal tickets of the company were wiped out.

One was the federal subsidies that made the production of low-income housing possible. Between 1981 and 1985, HUD saw its funds for housing assistance cut from $32 billion a year to $10 billion, the biggest reduction in any domestic program.

In addition, the Reagan administration's initial tax-reform plan, and the subsequent congressional plans, propose to eliminate many of the traditional tax incentives for investing in low- and moderate-income housing.

Under the tax bill passed late last year by the House of Representatives, for instance, the amount of tax deductions that investors can take for depreciation on low-income housing was sharply reduced. Meanwhile, the use of tax-exempt bonds — which have financed many low-income housing projects — would be curtailed as well.

As if these changes, which would undercut the company's traditional benefits for investors, were not enough, NCHP also has had to grapple with its own internal financial difficulties. The company was burned in the early 1980s by a number of expensive and ultimately unsuccessful ventures into single-family housing deals, while it also suffered a severe cash-flow squeeze at the beginning of last year.

Reported Profit in 1985

The company did report profits of $5.7 million in 1985 — largely on the strength of its property management affiliate — but Heller noted that much of the original capital raised for the firm has been eaten up over the years. As a result, he has sought since last year to raise additional capital for NCHP while trying to devise a new business strategy for the company.

One of the men he turned to was Warren Buffett, who has made millions on investments in The Washington Post Co., Geico Corp. and other companies. Buffett said he was put in touch with Heller through Lloyd H. Cutler, the former Carter administration official whose law firm Heller once worked for before coming to NCHP. He apparently liked what he saw.

"Right now, it is in a somewhat unpredictable phase, but that doesn't mean it's valueless," said Buffett, whose company is putting about $24 million into a new holding company for NCHP. "They've got a record of not making the local investor disappointed in them . . . . I think that a record of doing what you say in this field is a pretty good asset," he added.

Buffett also said that senior managers' investment of their own money in the company — at his insistence — would be an important performance incentive. Heller himself has purchased $740,000 worth of the new holding-company stock.

With Buffett on board, Heller was able to raise about $12 million from Weyerhaeuser Co. He and the other executives also simplified NCHP's corporate structure, and they say it should be easier now to raise even more capital in the future — perhaps with a public stock offering at some point.

NCHP Evaluating Its Mission

For now, however, management at NCHP is trying hard to figure out how to fulfill its mission — and make money — within the narrow parameters shaped by current federal housing policy. Indeed, under the circumstances, they insist there is little they will be able to do to produce new housing for

very low-income persons, a belief that disturbs some tenant and housing activists.

One lawyer who has represented some community-development groups said NCHP has been conservative in its approach to difficult housing projects in the inner cities while being reluctant to deal with local nonprofit groups. "They are acting very much like a traditional syndicator which is trying to maximize profits for private investors," said this source, who would not comment if he were named.

An NCHP proposal, subsequently dropped, to renovate the Abingdon Apartments in Alexandria is red meat for critics, who charged that the project would have displaced the very low-income tenants it was supposed to help. NCHP denied the charges, but Mark W. Looney, a housing official in Alexandria, said the company "seems to operate on its own with syndications rather than try to cooperate with the community or tenant groups."

Looney said that NCHP's overall role has been constructive, however. "Before a lot of these federal programs were eliminated, they had a very positive role in helping provide housing for low- and moderate-income families in Alexandria," he said.

As a result of the withdrawals of these subsidies, Heller said NCHP will try increasingly to tap state and local funds for development. But he also said NCHP will rely more on outside capital for individual projects than on its own equity as it has in the past; meanwhile, it will seek to beef up revenue through fee income — for instance, through its property management services.

Heller also said the company hopes to tap new sources of capital, citing pension funds and foreign

investors as promising possibilities. Heller noted that he has a tentative commitment from one pension fund to provide $100 million in funding for various NCHP projects.

"We have enormous responsibilities," said Heller. "We now own 80,000 units. Last year, we invested $5 million in advances to those projects for operating deficits. If we don't do that those projects will be ruined. They'll be urban slums or suburban slums.

"One can view what was done back in 1968 and '70 as a compact between private capital and Congress," Heller continued. "Congress said it would provide federal housing subsidies and a tax system which facilitated investment to the private investors. We in turn would provide the capital. Congress is breaking that compact . . . . We, however, are going to remain committed to that compact."

Rescue the Mitchell-Lama Housing Program

Edward C. Sullivan; Edward C. Sullivan,
a Democrat, represents Manhattan's 69th district
in the State Assembly.

The New York Times November 23, 1985,
Saturday, Late City Final Edition
SECTION: Section 1; Page 27, Column 1; Editorial

New York State's Mitchell-Lama program of housing for low- and middle-income families has provided decent homes for tens of thousands of people who could not otherwise afford them. It has rescued dying neighborhoods from terminal plight and created healthy, lively communities, integrated by race, income, ethnicity, age and life style. It has been a success story almost without parallel in the state. It is threatened with extinction.

A feature of the law that governs Mitchell-Lama housing provides that when a building has been occupied for 20 years, the owner may pay off the Federal- , state- or city government-held mortgage in full and take the building out of the program. Those 20-year periods are beginning to run out. One building, in Rochester, already has undergone a buyout. The result has been that rents have increased 50 percent, that senior citizens have been forced to leave their homes and that a building mostly financed with public funds will no longer fall into the moderate-income category.

The Mitchell-Lama program was established in 1955 in response to a legislative finding that a crisis existed in housing accommodations for people of modest means. The program set out to encourage the creation of new housing by offering loans and tax abatements to private developers. Today, there are

more than 400 Mitchell-Lama buildings on which the government holds mortgages.

If these mortgages are bought out by building owners, the effect on tenants would be similar to the Rochester experience at best -and, in many cases, much worse.

Rental buildings - one Mitchell-Lama category - are owned by real estate developers. If the mortgage of a rental building were bought out by the developer, the building would probably come under rent stabilization laws in those area that have such laws, The new rent, on which regulated rent increases are based under rent stabilization, might be the rent that the tenants were last paying under Mitchell-Lama, or it might be some much higher figure, depending on whether the tenants or the landlords won the inevitable struggles in state regulatory agencies and the courts.

A bought-out building would certainly lose its current Mitchell-Lama real estate tax abatement and it would undergo an upward revision of its assessment for tax purposes. Together with the cost of financing the buyout itself, these factors would greatly increase the cost of running the building. The landlord doubtless would try to pass these increased costs along to the tenants in the form of raised rents.

The landlord could, of course, decide to convert the building into a cooperative. Without rehashing the many tribulations that such a process always brings, it can safely be said that in the vast majority of affected buildings the landlord would reap millions and the apartments would never again be available to low- or middle-income families.

Co-op buildings - the second Mitchell-Lama category - are owned by the residents. If they should decide to buy out the mortgage and take the building out of the Mitchell-Lama program, the apartments could then be sold on the open co-op market. A resident's original investment of around $4,000 could bring in more than $200,000.

For a lucky few, this would be a giddy windfall similiar to winning the lottery or an Atlantic City jackpot - from a mostly publicly financed project. However, the windfall would go only to those residents who sold and moved out. Those who would prefer to remain in their homes would get increased taxes and financing costs. In many cases, the monthly maintenance charges for those who remained in the co-op would double. And, as with the rentals, the units in a bought-out co-op would never again be available to low- or middle-income families.

The crisis in moderate-income housing still exists. And at a time when New York State is about to embark on a multibillion-dollar development program for low- and middle-income housing, it would seem fiscally irresponsible to allow what we have in hand to slip away.

Legislation to delay the buyouts and save Mitchell-Lama housing must be passed and signed into law soon.

Tax Reform Could Be Painful

Byline: Kenneth R. Harney

The Washington Post
SECTION: Real Estate; Virginia;
The Nation's Housing

November 17, 1984,
Saturday, Final Edition

Ronald Reagan's massive reelection victory could have important financial consequences for tens of thousands of taxpayers who counted themselves in the president's corner politically: real estate owners, small-scale investors, home builders and realty brokers.

Capitol Hill and Treasury sources familiar with the broad outlines of the forthcoming tax-reform package being readied for the White House agree that:

- Real estate will be among the most dramatically affected sectors of the economy touched by the tax plan.
- Pushing the program hard on Capitol Hill early in the new Congress will be the Reagan administration's number one post-election domestic priority.
- Presidential promises of "no tax increase" notwithstanding, large numbers of individual real estate owners — including small-scale investors in condominiums, rental houses and apartment buildings — inevitably would pay higher taxes under the coming tax-reform proposals.
- The dollar resale value of many forms of real property — particularly those purchased,

financed or rehabilitated with current federal tax assistance — would decline if such incentives were abruptly withdrawn.

As one top congressional tax expert put it last week, "There is absolutely no way that the loopholes and preferences that have accumulated in the federal tax system are going to be cleaned out without hurting real estate. We take that as an inescapable fact of life."

The Treasury's tax package, under intensive development since last spring, won't be unwrapped officially until early December. Government sources confirm that it will propose a modified flat-tax concept — one that cuts individual and corporate income tax rates while jettisoning or restricting longtime tax deductions and credits.

The Treasury plan reportedly will bear similarities to the so-called Bradley-Gephardt and Kemp-Kasten bills introduced on Capitol Hill last session. The first measure, named for authors Sen. Bill Bradley (D-N.J.) and Rep. Richard A. Gephardt (D-Mo.), would end preferential capital-gains taxation for all investments, eliminate deductions for interest expenses except those for home mortgages, eliminate all nonrefundable investment tax credits, and lengthen the customary depreciation term for investment real estate to 40 years, up from the current 18 years.

In exchange for these and other reforms, Bradley-Gephardt would tax individual incomes at graduated rates ranging from 14 percent to 30 percent. Corporations would pay a flat 30 percent of their taxable income.

The Kemp-Kasten bill, co-authored by Rep. Jack Kemp (R-N.Y.) and Sen. Robert Kasten Jr. (R-Wis.),

would tax individuals at a flat 25 percent rate and corporations at graduated rates between 15 and 30 percent. Like Bradley-Gephardt, it would eliminate numerous investment tax credits and preferences, and leave home-mortgage interest deductions unscathed. Unlike the Democratic-sponsored bill, though, Kemp-Kasten wouldn't change the standard depreciation term for property owners.

The problem posed for real estate by modified flat-tax plans such as these is whether their undoubted attractions — lower standard tax rates and simplification of the federal-tax code -fully compensate for the loss of decades' worth of tax incentives.

For example, with lower individual tax brackets, would sufficient capital flow into sectors of the economy that traditionally have depended upon tax incentives to attract private investors, such as low- and moderate-income housing?

Would urban real estate undergo the sort of rehabilitation boom currently under way without the 15 to 25 percent investment tax credits for historic and other property recently added to the code? Would the country's large number of vacation homes and small-scale residential rental properties fall in value — perhaps by 15 to 25 percent — if interest, property taxes, accelerated depreciation and other deductions no longer sheltered taxable income? Even if current owners were grandfathered, allowed to retain their deductions for a period of years, wouldn't the reforms depress demand for such investments by future buyers?

Questions such as these are beginning to be posed by economists and financial analysts. The preliminary answers have some observors deeply concerned.

Analysts at Sears & Roebuck's Coldwell Banker Commercial Real Estate Services, for instance, recently computed the dollar impact of Bradley-Gephardt on typical investment transactions.

In its current form, according to Coldwell-Banker, Bradley-Gephardt would cut the annual investment return on an actual building now under construction in southern California by nearly one-half. Since the value of the tax deductions available from the structure would be severely diminished, according to the analysis, the price of the land underneath the building would have to be cut by 40 percent in order to provide the same yield to a future investor under a modified flat tax.

Such steep slashes in real estate returns and values — if confirmed by congressional, academic and industry studies — could create heavy opposition to tax reform next year on Capitol Hill, Reagan landslide or no.

Housing Values May Fall, Costs of Ownership Rise Under New Tax Measure; Low-Income Projects Face Finance Squeeze

By Ann Mariano, Washington Post Staff Writer

The Washington Post
SECTION: Real Estate
August 23, 1986, Saturday, Final Edition

New credits for low-income-housing investors provided in the tax reform bill would not make up for the loss of generous tax incentives the legislation would take away, representatives of housing organizations and investment groups said this week.

Severe restrictions on the use of tax-exempt bond proceeds, another source of low-income-housing funds, also will cut heavily into the supply of financing, they said.

Several million poor Americans live in low-rent housing built by private developers using money from investors seeking tax shelters. If the bill approved by the House and Senate conference committee is passed by Congress and signed by the president, most of the present tax deductions would be wiped out and replaced by three tax credits.

In the view of many low-income-housing experts, however, the legislation's most serious drawback is the absence of provisions to protect the tax benefits of current investors. The new credits are available only to people who make investments after Dec. 31 this year.

Although low-income housing received more favorable treatment from the House and Senate tax conferees than other real estate industry segments, the legislation could result in fewer — new or

rehabilitated units for the poor and widespread defaults or deterioration of existing projects as present investors lose their tax deductions, the critics said. "How can you expect people to invest in low-income housing if those who have invested in the past have had those benefits washed away?" asked Charles Edson, a Washington attorney whose law firm specializes in low-income housing.

Cushing Dolbeare, head of the National Low-Income Housing Coalition, said, "We calculate that investors in 325,000 units are threatened" with the loss of tax benefits. "Between a quarter and a third are almost certain to default." She said that low-income housing groups "are doing our level best" to persuade the tax committee to extend the bill's coverage to current investors.

Although some committee members are sympathetic to such pleas, they do not hold out much hope for further changes, according to several housing experts and congressional staff aides.

"The conference clearly rejected exceptions" in the new bill and probably would not "look favorably on a transition rule that not only is a similar exemption but would cost a significant amount of revenue," said John Sheiner, tax aide to Rep. Charles R. Rangel (D-N.Y.). Rangel "is a little distressed" about the retroactive effects on low-income housing, but said the legislation would be "politically difficult to change."

An aide to Sen. George 3. Mitchell (D Maine), said, "We're pushing" changes to protect investors and believe they could be fashioned so they would cost only about $400 million. "But we don't know how it will work out."

The bill's most sweeping change for real estate is elimination of the so-called passive loss provision, which permits investors to deduct expenses and losses connected with property from all sources of income, including salaries and earnings from other types of investments.

Under the new legislation, most taxpayers could deduct expenses and losses on the property only from the income generated by that real estate. Passive losses would be preserved for rental housing, however, with up to $25,000 in passive losses allowed for low-income-housing investors with incomes totaling no more than $250,000.

But as the bill stands now, current investors would not receive these benefits or the ones they expected when they made investment commitments.

Attorney Lawrence J. Ross, former chief counsel for the House Ways and Means oversight subcommittee, used the case of an investor in a low- and moderate-income housing project in the Maryland suburbs of Washington to demonstrate the potential impact. If the investor contributed $75,000 to the project over seven years, beginning in 1986, he would see his losses mount to $69,234 by 1992 without the existing tax benefits, rather than doubling his money as he expected to do when he committed himself to the deal last year, Ross said.

Faced with these losses, the investor, who thus far has paid only the $9,000 contribution required for 1986, might well choose to default on the commitment, Ross said. When tax losses taken in 1985 and 1986 are subtracted from his cash investment and responsibility for a share of the total debt, he would

have to pay only $8,142 in taxes in 1987 if he defaulted, according to Ross.

Although the investor could deduct his losses in 10 years or so when the property could be sold, the tax value of the losses would be greatly diminished by inflation. In most cases, tax breaks are the only incentives for low-income-housing investments, because restrictions on the project hold down income from rents or appreciation of the property, he said.

A defaulting investor in a real estate syndication could expect to be sued by the general, or responsible, partner and would face the possibility of a black mark on his credit rating, but probably would not be permanently damaged, Ross said. "Thousands of investors will be dealt a devastating blow by the tax bill , and they could explain to future lenders why they defaulted," he said. The cost of a lengthy lawsuit against defaulting investors also may discourage many general partners from going to court.

For future low-income-housing investors, tax credits of 9 percent of their investment each year for 10 years would be available on new construction or rehabilitation. When projects get other federal subsidies, such as mortgage insurance or rental assistance for tenants, the credit level drops to 4 percent a year. Buyers of existing housing for low-income use also could qualify for the 4 percent credit annually. The credits are available for the low-income units only. Under the present law, an entire project qualifies for tax benefits even if only a portion of the units are occupied by poor residents.

In another departure from current law, more of the housing must go to the very poor to qualify for credits. Owners must lease at least 20 percent of the

apartments in a project to families with incomes of 50 percent of the area median or less, after adjustment for family size, or at least 40 percent of the units to families with incomes 60 percent or less of the area median. Under current law, most tax benefits are available to projects housing families having incomes equivalent to 80 percent of the area median, without an adjustment for family size.

"Once people learn about the credits, I believe they can be a very effective tool," Edson said. "Whether the 9 percent credit will work without other federal assistance" going into a project is unclear.

The total amount of low-income housing credits available in a state is capped at a sum equal to $1.25 per resident, with state governments making the decisions about who will receive them. People working with federally assisted developments fear state governments will pass over these projects in favor of state-aided housing if there aren't enough credits to go around.

One such project is Paradise Manor, a 672-unit complex in Northeast Washington, where 470 apartments would qualify for the new tax credit. The nonprofit owner, the Mayfair Foundation, wants to sell Paradise Manor as a way to finance renovation of the project, but uncertainty about tax legislation has discouraged investors.

If the tax bill becomes law in its present form, the District of Columbia will have about $750,000 worth of tax credits to distribute next year. Paradise Manor would qualify for $272,600 in tax credits, or more than a third of all credits available in the District, according to Marilyn Melkonian, head of Telesis Corp., a consulting firm.

A $75 per-capita state cap on tax-exempt bonds, or $250 million, whichever is greater, also would mean a "dramatic curtailment" in bond financing for low-income housing, said Carolyn Seely, an attorney who works with low-income housing. The cap would drop to $50 per state resident in 1988.

Under current law, there is no limit on bond financing for multifamily housing projects with some units set aside for poor residents. Now this housing, along with mortgage revenue bonds, will be under the cap, along with all other projects for which state and local governments use tax-exempt bonds.

Low-income housing "will not be able to compete very successfully" with roads, convention centers and more popular projects, she said.

[LOGO]
Empire State Development

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January 29, 1999

Jerry Barber, Audit Director
Office of the State Comptroller
A.E. Smith State Office Building
Albany, New York 12236

Re: Draft Audit Report 97-S-33

Dear Mr. Barber:

Pursuant to your request, enclosed find four (4) copies of our response to Draft Audit Report (97-S-33) on the New York Slate Mortgage Loan Enforcement and Administration Corporation's administration of debt service for Mitchell-Lama projects to be included as an appendix to your final report.

Very truly yours,

/s/ Larry H. Sutton
Larry H. Sutton

Enclosures

RESPONSE TO DRAFT REPORT 97-S-33 MORTGAGE LOAN ENFORCEMENT AND ADMINISTRATION CORPORATION ADMINISTRATION OF DEBT SERVICE FOR MITCHELL-LAMA PROJECTS

The Auditors demonstrated a fundamental lack of understanding of the nature and purpose of MLC. Such lack of understanding is evident throughout the Audit.

EXECUTIVE SUMMARY

AUDIT OBSERVATIONS AND CONCLUSIONS

The projects that receive interest subsidies from the United States Department of Housing and Urban Development were underwritten on that basis and therefore it was never anticipated that such projects would generate sufficient revenue to pay operating expenses and debt service obligations without such subsidies.

The Audit ignores the fact that in many cases where a housing company has worked out its past due debts, the project's financial standing has significantly improved and certain projects, which previously have not paid any debt service, have begun to pay a portion of such debt service.

The Audit states that the auditors "found that funds authorized for repairs have been used instead for operating expenses" while in reality, funds authorized for repairs were utilized only once to fund operating expenses in a case where the funds were necessary to avoid a electric turnoff by the utility company. All persons required to sign off on such advance were fully informed that such use was not

for the purpose authorized by the various Boards of Directors.

MANAGEMENT OF PORTFOLIO

The projects that receive interest subsidies from the United States Department of Housing and Urban Development were underwritten on that basis and therefore it was never anticipated that such projects would generate sufficient revenue to pay operating expenses and debt service obligations without such subsidies. Such subsidies are paid directly to the mortgagee and do not affect the operating income of the projects. The "fifteen (15) subsidized projects not paying debt service" means that only the housing company's portion of the debt service, which represents approximately twenty (20%) per cent of the annual debt service requirement, is not being paid. The eight (8) projects, for which operating funds are being provided, represent, at this time, the only projects where operating expenses exceed actual cash receipts from rent.

RESTRUCTURING AGREEMENTS

While workout agreements have not reduced project arrearages, that was not the intent of such workout agreements. The primary goal of MLC is to keep the housing projects self-sufficient and, on behalf of the New York State Urban Development Corporation, the New York State Project Finance Agency and the New York State Housing Finance Agency, to maximize the collection of debt service from the projects. Such collections, in addition to the HUD interest subsidy, are used to service bonds issued by the aforesaid agencies, as well as to cover certain operating costs of such agencies and the New York State Division of Housing and Community

Renewal. Increases in outstanding debt are traded against the production of current income and the production of funds necessary for project repairs for which UDC might otherwise have to advance funds.

The Auditors noted that "MLC did not have written guidelines to assist in determining when to use a workout agreement and how to construct its terms and conditions". Each project in the UDC/PFA housing portfolio is unique, with different problems and different ownership entities. It is not possible to construct a working model for terms and conditions. Each workout agreement is usually the result of many months or possibly years of negotiation.

TRACKING OF DEBT SERVICE ARREARS

The arrearage balance of the portfolio as a whole has no bearing on the ability of projects to pay debt service or operate the project. There has never been any point to report the entire arrearage for the portfolio at any given time. When the portfolio has been subject to due diligence investigations for various bond issues, only the underlying mortgages, not the arrearages, and the HUD subsidies have been considered. On an individual project basis, MLC can provide updated arrearage information for any date. At the request of the auditors, such arrearage information was produced in a short time.

BILLING AND COLLECTION DOCUMENTATION

The Auditors criticize MLC's reporting of debt service collections because such collections are not stated as a percentage of the total outstanding mortgage debt. MLC's preparation of data showing the percentages of annual debt service billings collected is not intended to be used to indicate the amount of the total outstanding debt collected but

rather to allow a comparison of actual collections from month to month or year to year. In order to allow such comparison, the basis must remain consistent. Since the total debt increases, MLC utilizes the contractual FMD mortgage amounts which remain fairly constant. There is no representation that such reported percentage represents a portion of the total debt.

LOANS AND ADVANCES

Funds are advanced to projects to protect the interest of the mortgagee, and the health and safety of project occupants. Such advances are also utilized to keep the projects in compliance with HUD requirements to insure the payment of the interest subsidies to fund the debt service payments on various bond issues. Except for the Project Improvement Program, funds advanced are mostly for emergency situations and are reactions to particular problems. In such cases, while the cost of remedying the situation is considered, the cost effectiveness of the advance is not the main issue. Emergencies need to be handled immediately and because of the diverse nature of the emergencies, it is not possible to develop consistently applicable criteria for the distribution of the funds.

SECTION 32 ADVANCES

All Section 32 advances are approved by the MLC, UDC and PFA (if required) Directors. There is always documentation supporting the need for advances. All repair requests are inspected by either MLC or the New York State Division of Housing and Community Renewal to determine need prior to the submission to the various directors for approval. In all cases the availability of other sources of funds is explored first. In conducting the audit, the auditors reviewed the

individual files of MLC Project Accountants which only contained the forms necessary to actually draw down approved advances. They did not examine the backup documentation. They also did not recognize the imput of the New York State Division of Housing and Community Renewal in MLC's supervision of the portfolio. Article 2 of the Private Housing Finance Law and a Memorandum of Understanding among New York. State Division of Housing and Community Renewal, MLC, UDC and PFA sets forth the specific responsibilities of MLC and New York State Division of Housing and Community Renewal. Many Section 32 mortgage advances are recommended by New York State Division of Housing and Community Renewal based upon their inspection of the project and knowledge of the lack of project funds.

PORTFOLIO REPAIR AND IMPROVEMENT ACCOUNT

The Portfolio Repair and Improvement Account was set up to handle emergency repairs where it is impossible to obtain Directors approval of a Section 32 mortgage advance on a timely basis. Section 32 mortgage advances require the approval of at least two separate Boards of Directors and sometimes thee. With the consent of the MLC directors, the account has been utilized occasionally for the emergency need for operating funds to avoid a utility cutoff or tax foreclosure or similar circumstance. In such case, the Directors were subsequently requested to and did approve a Section 32 mortgage advance which was used to reimburse the Portfolio Repair and Improvement Account.

PROJECT IMPROVEMENT PROGRAM

The Auditors stated that they did not find independent verification that PIP funds were actually needed

and that the approval of loans was based upon assertions in the projects' applications. MLC and the New York State Division of Housing and Community Renewal administer the Project Improvement Program on behalf of the New York State Housing Finance Agency under a Memorandum of Understanding. The applications for PIP funding arc submitted to DHCR Independent of the PIP application, MICR requires all Projects to submit Physical Condition Surveys by an independent architect or engineer in order to adjust the project's replacement reserve requirements. The Physical Condition Surveys, when available, arc reviewed by DHCR. at the time of the PIP application, and utilized in determining the need for PIP funds. DI ICR also reviews the projects' replacement reserve to determine if the project has sufficient funds to fund all or part of the improvements which are contained in the PIP application. Unless the requested improvement is an item, that did not require an inspection, such as smoke detectors, fireman's service in elevators or heat conversions, the project is inspected by either MLC, DHCR or the independent architect or engineer. After all relevant information is obtained, MLC and DHCR representatives meet and agree on PIP loans for various projects.

While MLC officials themselves do not always make an independent verification that work has been completed before approving progress requisitions, in such cases verification is made by either DHCR or an independent architect or engineer hired to supervise and certify the work. Requisitions are not approved unless the completion of the work is certified by an independent architect or engineer or inspected by either DHCR or MLC.

TRACKING AND TIMELINESS OF INSPECTIONS

Although for a period of approximately a year, because of staff reductions and the focus on inspecting projects receiving PIP loans, MLC was unable to perform an annual inspection on all the projects in the portfolio, the projects were inspected by DHCR. Under the Memorandum of Understanding, it is DHCR's responsibility to insure that dangerous conditions at the projects are repaired or corrected in a timely manner. MLC only becomes involved where the project has insufficient funds to effectuate the correction of the condition. If MLC discovers a problem at a particular project either through its annual inspection or in any other manner, the matter is referred to DCHR for correction. During the period where MLC was not inspecting the projects, the projects were being inspecting by independent engineers or architects pursuant the directive of MICR that all projects complete physical condition surveys.

All identified dangerous conditions at the projects have been corrected in a timely manner.

COORDINATION WITH DHCR

All DHCR Management Field Reports are forwarded to MLC and review when received. If MLC does not have copies of a DHCR Management Field Report for a particular project, it is because DHCR did not inspect that particular project or the Report was delayed at DHCR.

EXCESS CASH RECOVERIES COLLECTION OF EXCESS CASH

In analyzing overfunding of a particular project's operating escrow account, the auditors constantly refer to a required balance, which is actually an an-

nual funding requirement, and state that the actual balance is well in excess of that required balance. The balances in the projects' replacement reserves are by no means overly generous for a project of its size. It is not MLC's goal or in the interest of the mortgagee to strip a project of all excess cash or reduce a project's replacement reserve account to an unacceptably low level. The result is that if an emergency situation arises at the project it might not have sufficient funds to remedy the situation and thus require additional advances by UDC.

State Comptroller's Note:

Certain matters addressed in the draft report were revised or deleted in the final report. Therefore, some agency comments included in Appendix B may * * *

State of New York
Office of the State Comptroller
Division of Management Audit
and State Financial Services

MORTGAGE LOAN ENFORCEMENT AND ADMINISTRATION CORPORATION

ADMINISTRATION OF DEBT SERVICE FOR MITCHELL-LAMA PROJECTS

REPORT 97-S-33

[LOGO]

H. Carl McCall
Comptroller

State of New York
Office of the State Comptroller

Division of Management Audit and
State Financial Services

Report 97-S 33

Mr. Larry Sutton
General Counsel
New York State Mortgage Loan Enforcement
and Administration Corporation
633 Third Avenue
New York, NY 10017-6754

Dear Mr. Sutton:

The following is our report on the Mortgage Loan Enforcement and Administration Corporation's administration of debt service for Mitchell-Lama projects.

This audit was performed pursuant to the State Comptroller's authority as set forth in Article X, Section 5 of the State Constitution and Article II, Section 8 of the State Finance Law. Major contributors to this report are listed in Appendix A.

Office of the State Comptroller
Division of Management Audit and
State Financial Services

June 22, 1999

Executive Summary

Mortgage Loan Enforcement and Administration Corporation

Administration of Debt Service for Mitchell-Lama Projects

Scope of Audit

During the late 1960s and early 1970s, the Urban Development Corporation (UDC), a public benefit corporation created by the State Legislature, issued bonds to finance the development of 113 housing projects (projects) throughout the State for low-income and middle-income families. The projects were developed by private housing companies (companies) in accordance with provisions of the New York State Private Housing Finance Law, known as the Mitchell-Lama Law. The companies were allowed 40 years to repay UDC both the principal and interest on their loans. Many of the projects also received subsidies from the Federal government. Of the original 113 projects, 108 remained in the program as of December 1997.

In the mid-1970s, it became clear that many of the UDC projects were not financially viable; the cash flow from rent receipts was not enough to cover operating expenses and debt services. As a result, these projects had significant arrearage in debt service. In response, UDC created the Mortgage Loan Enforcement and Administration Corporation (MLC) in 1979 as a subsidiary corporation that would service the housing mortgage portfolio by billing and collecting mortgage debt. In addition, MLC can negotiate agreements with the companies to reschedule past-due and current debt and can advance additional funds. The mission of MLC and its staff of 13

includes improving debt service collections, monitoring projects and maintaining and improving projects' financial and physical condition.

Our audit addressed the following questions about the administration of debt service by 1VILC for the period July 1, 1992 through March 31, 1998:

- Has MLC been successful in reducing project arrearage?
- Was MLC properly advancing additional funds to projects and was MLC adequately monitoring the use of these funds?
- Did MLC provide effective monitoring of the physical conditions of the projects?
- Did MLC identify and collect excess amounts of cash being held by the projects?

Audit Observations

Staffing limitations have hindered MLC's ability to implement certain and Conclusions control procedures. In December 1996, MLC contracted with Greystone Servicing Corporation (Greystone) to gradually assume responsibility for most of MLC's operations. We believe our audit results should be helpful to MLC in directing Greystone to strengthen operational controls.

We noted that without subsidies, 80 of the projects in MLC's portfolio would not have enough revenues to pay their operating expenses and to fund their debt service obligations. In addition, MLC continues to authorize additional funding to the projects in the form of loans and advances. As a result, the debt load of the projects in MLC's portfolio continues to increase. We believe that MLC should develop short and long range strategic plans that address growing

debt arrearage as well as the role for workout agreements and foreclosures. (See pp. 5-8)

When we examined the loans made to sampled projects, we found a lack of evidence and documentation that would demonstrate that the funds were needed. In addition, we found indications that MLC did not always ensure the projects were inspected before the loans were authorized. (See pp 13-17)

MLC had no guidelines for its inspection of the physical condition of the projects 72 of the 108 projects had not been inspected during the last year of our audit period. Also, in two instances where MLC inspectors found hazardous conditions, there was no follow-up to verify implementation of the corrective steps that reportedly had been taken, (See pp. 19-22)

MLC analyzes project financial data to determine whether the projects have excess funds that could he used to pay down past-due amounts. However, we found no documentation indicating the procedures that MLC follows in performing such an analysis or collecting the excess funds that were identified. MLC staff have not been consistent in the methodologies they use to determine the availability of excess cash and they do not analyze the excess cash possibilities for all projects in arrears. (See pp 23-26)

Comments of MLC Officials

MLC officials disagree with several of our findings and conclusions and do not specifically respond to our recommendations.

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Introduction

Background

During the late 1960s and the early 1970s, in accordance with provisions in Article 2 of the New York State Private Housing Finance Law, known as the Mitchell-Lama Law, the New York State Urban Development Corporation (UDC) financed the development of 113 housing projects (projects) for low-income and middle-income residents Initially funded by the proceeds of bonds issued by UDC, these projects were to be built and operated throughout the State by housing companies (companies) organized for that purpose. The $1.1 billion of loans financing the construction were secured by liens. The Empire State Development Corporation (ESDC) assumed UDC's role in 1995. Currently, 108 projects, containing 31,000 apartment units, remain in this portfolio. As of March 31, 1997, approximately 28,500 of the apartments were occupied; occupancy rates at each project ranged from 28 percent to 100 percent. Under Section 236(B) of the National Housing Act of 1934, interest payments are reduced for 98 projects through subsidies from the U.S. Department of Housing and Urban Development (HUD). Currently, these annual subsidies exceed $58 million,

In 1975, after UDC was unable to make timely payments on its debt obligations and could not finance completion of some of the projects, the State created the Project Finance Agency (PEA). PEA received State appropriations of $198.1 million and issued bonds and notes for $280 million, using the proceeds to purchase 26 Section 236(B) subsidized mortgages from UDC.

During the 1970s, as it became increasingly apparent that rent receipts for many UDC projects were insufficient to cover both operating expenses and debt service, an aggressive program to stabilize the UDC and PEA mortgage portfolios was initiated. In 1979, UDC organized the Mortgage Loan Enforcement and Administration Corporation (MLC) as a subsidiary corporation to service the UDC and PFA portfolios, retaining 51 percent of the ownership and assigning the remaining 49 percent ownership to PEA. MLC's mission includes improving debt service collections, monitoring projects and maintaining and improving projects' financial and physical condition, MLC's service responsibilities include the preparation of billing statements and the monitoring of account status. MLC is also responsible for negotiating workout agreements with projects, initiating foreclosure proceedings, inspecting projects, providing additional financing as specified in Section 32 of the mortgage agreement, and authorizing other loans and advances to projects from various sources.

MLC, which employs a staff of 13, contracted in December 1996 with Greystone Servicing Corporation (Greystone) to service its mortgage portfolio. Greystone is expected to assume MLC's data processing and project inspection functions, hut this transfer had not been completed as of the end of our field work.

Audit Scope, Objectives, and Methodology

We audited MLC's administration of debt service for the projects in its portfolio for the period of July 1, 1992 through March 31, 1998. The objectives of our performance audit were to determine whether MLC was successfully stabilizing the financial conditions of the projects, properly advancing additional funds

to projects, adequately monitoring the use of advance funds, effectively monitoring the physical conditions of projects and was identifying and collecting excess project cash. To accomplish our objectives, we interviewed MLC officials and reviewed their records, including those for judgmentally-selected samples of projects

We conducted our audit in accordance with generally accepted government auditing standards. Such standards require that we plan and perform our audit to adequately assess those operations of MLC which are included within our audit scope. Further, these standards require that we understand MLC's internal control structure and its compliance with those laws, rules and regulations that are relevant to the operations which are included within our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances.. An audit also includes assessing the estimates, judgments, and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions, and recommendations.

We use a risk based approach when selecting activities for an audit. We therefore focus our audit efforts on those operations that have been identified through a preliminary survey as having the greatest probability for needing improvement. Consequently, by design, we use finite audit resources to identify where and how improvements can be made. Thus, little effort is devoted to reviewing operations that may be relatively efficient or effective. As a result, our audit reports are prepared on an "exception

basis." This report, therefore, highlights those areas needing improvement and does not address activities that may be functioning properly.

Response of MLC Officials to Audit

A draft copy of this report was provided to MLC officials for their review and comment. Their comments have been considered in the preparation of this report and are included as Appendix B.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the General Counsel of the Mortgage Loan Enforcement and Administration Corporation shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

EXHIBIT M

THE LEGISLATIVE HISTORY OF THE § 502 EXEMPTION

The events leading up to the enactment of this limited exemption are of significance in evaluating its reasonableness.

The passive loss provision was first proposed in a Senate Finance Committee Report issued in May 1986, over five months after the House version of the 1986 Act had been passed. There were never any hearings on the Senate proposals. On the floor of the Senate, the manager of (Senator Packwood) took the position of opposing all amendments to the Bill on the grounds that if one amendment was passed, a whole series of amendments would follow (132 Cong. Rec. S8133 (daily ed. June 23, 1986)).

An amendment (Amend. 2153) was introduced by Senator Mitchell, having 19 co-sponsors, to completely exempt low and moderate income housing from the passive loss provision. On the floor of the Senate, Senator Packwood averted a vote on the amendment by promising that in the Conference Committee the Senate would support an exemption for low and moderate income housing. In this regard, he stated:

> "Mr. President, I appreciate the point that the Senator [Mitchell] has made today with regard to the need for special transition treatment for existing investment in low-income housing. I must say that I agree with the distinguished Senator that low-income housing investments are indeed different than other investments affected by our committee amendment and that they deserve special treatment. I want to assure

> both Senators that when we take up this matter of transition rules in the Conference Committee, I will do my utmost to insure that these investments receive special consideration. Although I continue to believe that the changes in the committee amendments which lower rates and broaden our tax base more than offset the passive losses which our amendment would restrict in the future, I agree that investments in low-income housing are different from other investments in real estate and they deserve the most favorable treatment which can be provided. 132 Cong. Rec. § 8149 (daily ed. June 23, 1986)."

This promise was never kept. The Conference Committee took no action on an exemption for low and moderate income housing.

At the last minute, House Speaker O'Neill achieved the addition to the bill of a limited exemption for prior investments in housing projects - However, in order to secure the passing of the amendment, the Speaker was forced to give to the supporters of the bill a proviso that the exemption would apply only to investors who had not yet paid in at least 50% of their committed investments. It would not apply to investors who had already paid in 50% or more of their full commitments, even if they had invested in the same projects as persons who had not yet paid in at least 50% of their committed investments.

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EXHIBIT N

REVENUE RULING 79-300 1979-2 C.B. 112

Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Revenue Rulings (1954 to Present)
1979

Headnote:

Rev. Rul. 79-300, 1979-2 CB 112 -- IRC Sec. 183

Reference(s): Code Sec. 183; Reg § 1.183-2

Nonprofit activity; low and moderate income housing.

The construction and operation of an apartment project for low and moderate income housing under section 236 of the National Housing Act is not an activity to which section 183 of the Code applies.

ISSUE

Is the construction and operation of an apartment project for low and moderate income housing under section 236 of the National Housing Act an activity to which section 183 of the Internal Revenue Code applies?

FACTS

A limited partnership was organized to construct and operate an apartment project consisting of 300 units of low and moderate income housing. The apartment project is financed by the state Housing Development Authority under section 236 of the National Housing Act (the Act), as codified at 12 U.S.C. sections 1701, 1715Z-1, and as enacted by the Housing and Urban Development Act of 1968, 82 Stat. 476 (the Act of 1968), Pub. L. 90-448, 1968-2 C.B. 734, which subsidizes mortgage payments. This

program is administered by the U.S. Department of Housing and Urban Development through the Federal Housing Administration.

Under section 236 of the Act, the state Housing Development Authority made a 20-year loan to the limited partnership for 90 percent of the project costs. Because the partnership must operate the project in accordance with such requirements with respect to tenant eligibility and rents as the Department of Housing and Urban Development may prescribe, the partners anticipate that little or no funds will be available for distribution and that the partnership will sustain losses for federal income tax purposes each year during the 20-year period. For example, Part 236 of Housing and Urban Development regulations provides at 236.10(c) that the partnership shall be restricted as to distribution of income and shall be regulated as to rents, charges, rate of return, and methods of operation.

LAW AND ANALYSIS

Section 183(a) of the Code provides that in the case of an activity engaged in by an individual, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under Chapter One (Normal Taxes and Surtaxes) of the Code, except as provided by section 183.

Section 1.183-2(a) of the Income Tax Regulations provides that,

The determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer en-

tered into the activity, or continued the activity, with the objective of making a profit.

Although section 183(a) of the Code refers to an activity engaged in by an individual, it also applies to the activities of a partnership. See Rev. Rul. 77-320, 1977-2 C.B. 78, which holds that the provisions of section 183 are applied at the partnership level and reflected in the partners' distributive shares.

Section 901 of the Act of 1968 "declares that it is the policy of the United States to encourage the widest <Page 113> possible participation by private enterprise in the provision of housing for low or moderate income families." Consequently, the Act of 1968 added section 236 to the National Housing Act and contemplated the formation of partnerships as the vehicle for the participation of private investors in undertakings for the provision of housing primarily for families of low or moderate income, pursuant to federal programs or otherwise.

The Senate Committee on Banking and Currency described the incentive of such a partnership to investors as follows:

> The partnership arrangement makes it possible to assure an adequate return to investors. Under existing Internal Revenue Service regulations and rulings, partnership losses for tax purposes flow to the individual partners. In the case of new housing units financed on a 10-percent equity—90-percent debit basis, the annual accelerated depreciation of the building cost results in substantial book losses during the initial 10 years after the project is built. Assuming the member of the partnership is in relatively high income tax bracket, his share of the depreciation

losses, plus cash income from project operations would provide an after-tax return on his investment which would compare favorably with the return which most industrial firms realize on their equity capital.

S. Rep. No. 1123, 90th Cong., 2d Sess. 85 (1968).

When section 183 of the Code was adopted in 1969, the Committee on Finance expressed its desire that this provision would be reasonably administered and stated that the Service should limit the disallowance of the deduction of losses under this provision to cases in which it is generally recognized that this is appropriate. S. Rep. No. 91- 552, 91st Cong., 1st Sess. 103-104 (1969), 1969-3 C.B. 423, 490.

The above legislative history indicates that in limiting rental charges, Congress assumed deductions of tax losses would be allowed to encourage investment in projects providing decent housing for low or moderate income families under the Act. Consequently, application of section 183 of the Code to the present case would frustrate congressional intent in enacting the housing legislation. Therefore, section 183 will not be applied to disallow losses incurred in activities to provide low and moderate income housing under section 236 of the National Housing Act.

HOLDING

The construction and operation of an apartment project for low and moderate income housing under section 236 of the National Housing Act is not an activity to which section 183 of the Code applies. Consequently, the Service will not use the "not for profit" argument to deny related deductions under sections 162, 165, 167 and 212 of the Code.

EXHIBIT O

EVENTS LEADING TO PETITIONER'S INVESTMENT IN ALDUS

The events that led to my investment in Aldus were as follows:

I. In 1967, I volunteered to work pro bono for Senator Robert Kennedy on the development of tax incentives for private investment in:

A. low and moderate income housing, and

B. new businesses in the poverty areas.

I wrote to Senator Kennedy because of his work with the Bedford Stuyvesant organization (which was working for the restoration of a poverty area in Brooklyn, NY).

I was called by Senator Kennedy's legislative assistant, Michael Curzan, to work with him on a proposed tax incentive program. We drafted two major bills, one for housing and the other for poverty area business investment. The legislation was introduced with tremendous publicity. Hearings on the two measures were held before the Senate Finance Committee at which I testified along with Senator Kennedy. Favorable testimony and letters in support the bills were received from industry leaders, investment bankers (including, as I recall, a senior partner in Lazard Freres) and others.

II. A short time after the hearings, Mr. Curzan was called by a legislative assistant at the White House who said that the White House would like to work with us on the development of tax incentive legislation for low and moderate income housing, provided that Senator Kennedy did not share any of the

credit for the joint legislation. Senator Kennedy agreed to this condition and Mr. Curzan and I went to the White House where we worked on tax incentive proposals that were eventually enacted in the Housing and Urban Development Act of 1968 and the Tax Reform Act of 1969. These are described in Exhibit J in this Appendix.

III. In my last conversation with Senator Kennedy (a few days before he was assassinated), the Senator told me that if he won the election, he would appoint me to a subcabinet position in Treasury or HUD.

IV. In the succeeding years, I worked as an attorney for the City of New York (still as a volunteer) on applications for key tax rulings necessary to make the tax incentives available in New York. Under New York State laws, it was necessary that a governmental housing project loan be made to a corporation. However, for the tax benefits to be utilized, the investors had to participate through a partnership.

In negotiations with the City and the Internal Revenue Service, I developed a new structure under which the corporation to which the government loan was made would be acting as a nominee for a partnership. A favorable IRS ruling was granted stating that the partnership was the project owner for tax purposes. To my knowledge, this is the only case in which the IRS has positively ruled on the nominee status of a corporation which is holding title to a real property over an extended period as the nominee for a partnership.

As explained in the brief, the IRS issued another landmark ruling (Rev. Rul. 79-300, 1979-2 C.B. 112) stating that in view of the legislative history, investors in low and moderate income housing would not have to show a profit motive in order to deduct the losses.

V. In the course of this work, the New York City Mayor's Office and its Housing and Development Administration ("HDA") introduced me to Herman I. Kraus ("Kraus"). They advised that with HDA mortgage loans, Kraus had been developing low and moderate income housing. The development was done by gut rehabilitation of substandard poverty area properties and then managing the low and moderate income housing.

The NYC officials advised that Kraus' development, rehabilitation and management work was the most outstanding of any of the participants in their programs. They asked me to work with Kraus in raising private equity funds (based on the tax incentives) for development of low and moderate income housing. My work with Kraus was done on a paid basis with my firm's fees on a particular project being paid as one of the expenses from the proceeds of the equity offering.

VI. Kraus and I worked together on private placements of partnership interests in partnerships engaged in housing development with the gut rehabilitation and management work to be done by Kraus.

Based on the tax incentives, Kraus developed, and I worked with him in raising equity funds for, several important projects including projects known as Wil-

liamsburg–Buff and Williamsburg Green, in the poverty area in Williamsburg, Brooklyn, New York as well as the Aldus project in the South Bronx, New York.

VII. In each of the above projects, the mortgage financing was provided by a loan from the City or by a private lender with the mortgage being guaranteed by the United States Department of Housing & Urban Development ("HUD"), under the National Housing Act or the United States Housing Act. Kraus' rehabilitation and management work with many public officials including Senator Jacob Javits on the floor of the US Senate. The projects are still in excellent condition today and my work on the projects is the aspect of my professional career of which I am most proud.

In each of the projects, a major portion of the rents of low income tenants was paid by HUD under a long term (*e.g.*, 20 year) contract with the partnership under HUD's rent supplemental program or later the Section 8 program.

Processing the applications for HUD assistance for the projects were major undertakings involving:

A. preparation of detailed applications, and

B. preparation of supplemental information requested by HUD,

C. meetings with HUD often invoking political assistance (from Senator Javits).

Kraus' work was so outstanding that HUD granted contracts for assistance to certain of these projects even after the assistance programs had been scaled down and finally suspended by new administrations.

VIII. In the offering memoranda for each of these projects (including Aldus), it was explained that the sole basis for investment was a realization of tax incentives described in our brief and that there was absolutely no economic return from the project. Indeed, there was an assurance of economic loss, since the investors' equity investment would not be recouped by the proceeds of a sale. Indeed, the projections in the offering memoranda ended by showing a foreclosure on the project in which the investors would sustain an out of pocket tax.

IX. In 1974, I worked with Kraus on the offering of equity interests in the partnership that developed the Aldus project (referred to in the brief as the "Seller"). Many of my clients and my father's clients invested in the Seller.

In the early 1980s, I began to receive significant pressure from two groups of persons related to the Aldus project, that is:

A. partners of the Seller who had now passed the "turnaround point" after which they were realizing phantom income on the project and who desired a sale or other transfer of the project that would terminate this phantom income, and

B. other clients of my firm—who like many other extremely wealthy people in this period—were insisting that their counsel and accountants find them "legitimate tax shelters."

The latter persons were desirous of my offering them housing partnership investments since they were aware that low and moderate income housing was one of the only areas in which the tax shelter benefits had been clearly sanctioned by law and by the Internal Revenue Service.

My clients subscribed for part but not all of the interests in the Partnership. My personal investment was instrumental in achieving additional subscriptions for interests in the Partnership.

In 1983-1984, the Partnership was organized as described and purchased this product from the Seller as described in the brief.